FRANCHISING: IS SELF-REGULATION SUFFICIENT?

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC, APRIL 21, 1993

Printed for the use of the Committee on Small Business

Serial No. 103-9

U.S. GOVERNMENT PRINTING OFFICE

67-397 WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044055-6

FRANCHISING: IS SELF-REGULATION SUFFICIENT?

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC, APRIL 21, 1993

Printed for the use of the Committee on Small Business

Serial No. 103-9

U.S. GOVERNMENT PRINTING OFFICE

67-397 WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044055-6

COMMITTEE ON SMALL BUSINESS

JOHN J. LaFALCE, New York, *Chairman*

NEAL SMITH, Iowa
IKE SKELTON, Missouri
ROMANO L. MAZZOLI, Kentucky
RON WYDEN, Oregon
NORMAN SISISKY, Virginia
JOHN CONYERS, Jr., Michigan
JAMES H. BILBRAY, Nevada
KWEISI MFUME, Maryland
FLOYD H. FLAKE, New York
BILL SARPALIUS, Texas
GLENN POSHARD, Illinois
EVA M. CLAYTON, North Carolina
MARTIN T. MEEHAN, Massachusetts
PAT DANNER, Missouri
TED STRICKLAND, Ohio
NYDIA M. VELAZQUEZ, New York
CLEO FIELDS, Louisiana
MARJORIE MARGOLIES-MEZVINSKY, Pennsylvania
WALTER R. TUCKER III, California
RON KLINK, Pennsylvania
LUCILLE ROYBAL-ALLARD, California
EARL F. HILLIARD, Alabama
H. MARTIN LANCASTER, North Carolina
THOMAS H. ANDREWS, Maine
MAXINE WATERS, California

JAN MEYERS, Kansas
LARRY COMBEST, Texas
RICHARD H. BAKER, Louisiana
JOEL HEFLEY, Colorado
RONALD K. MACHTLEY, Rhode Island
JIM RAMSTAD, Minnesota
SAM JOHNSON, Texas
WILLIAM H. ZELIFF, Jr., New Hampshire
MICHAEL A. "MAC" COLLINS, Georgia
SCOTT McINNIS, Colorado
MICHAEL HUFFINGTON, California
JAMES M. TALENT, Missouri
JOE KNOLLENBERG, Michigan
JAY DICKEY, Arkansas
JAY KIM, California
DONALD A. MANZULLO, Illinois
PETER G. TORKILDSEN, Massachusetts

Jeanne M. Roslanowick, *Staff Director*
Stephen P. Lynch, *Minority Staff Director*

CONTENTS

FRANCHISING: IS SELF-REGULATION SUFFICIENT?

WEDNESDAY, APRIL 21, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359–A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Committee on Small Business will come to order.

Our hearing today continues the Small Business Committee's inquiry into key issues of business franchising. During the past 3 years, our committee has endeavored to bring before the Congress a variety of issues and problems involving both the sale of franchises to the public and the conduct of franchise business relationships. This effort has sought to emphasize the growing importance of franchising in our Nation's economy, and to highlight the benefits and the pitfalls of franchising as an avenue for small business ownership and as a method for promoting small business growth.

Since the committee's last formal hearing on franchising last July, I have noticed a shift in the focus of public debate over franchising—from arguments of whether serious problems exist in franchise sales and relationships to discussion of appropriate methods for addressing any problems or abuses that may exist. I see this as an extremely important and promising development.

In May of 1991, I had the pleasure of addressing the annual legal symposium of the International Franchise Association, the IFA, where I outlined the problems the committee had found in more than a year of investigation into franchising, and offered the resources of our committee to assist the IFA's membership to initiate a broad discussion of franchising problems and appropriate remedies.

I explained my own philosophy of regulation as one emphasizing "what the private sector should and can do voluntarily, it should do; but what the private sector cannot do, Government should attempt to regulate for the purposes of the public good."

I also expressed my belief that it was imperative for the assembled franchisors "to begin to address the problems of franchising to assure that their reputations remain unblemished by the actions of others, and to assure that abuses in the industry do not lead to unnecessary or excessive regulation."

I meant those words when I said them 2 years ago, and I continue to believe them today. Unfortunately, the type of broad, constructive dialog between franchisors, franchisees and public officials which I had hoped to encourage at that meeting did not ensue.

In recent months, however, we have seen important signs of change. The incoming chairman of the IFA and several former IFA chairmen have made public statements calling on franchisors to move beyond the "we versus them" mentality that has come to dominate attitudes toward franchisees and to seek increased cooperation and partnership.

Last fall, the IFA revised its code of ethics to attempt to respond to many of the grievances expressed by franchisees. More recently, the association has proposed a number of new initiatives to facilitate alternative dispute resolution mechanisms, franchisor-franchisee councils and, even, eventual full membership in the association for franchisees. Influential voices within and outside the IFA have also called for concrete and meaningful steps toward industry self-regulation.

I would like to believe that the activities of this committee may have been responsible at least in part for some of these positive developments.

The purpose of today's hearing is to initiate public discussion of self-regulation and franchising. Our committee is interested in the details of such initiatives, now being undertaken, and the outlines of those contemplated for the future.

What forms should self-regulation take? How broadly would it apply? What enforcement mechanisms are contemplated?

Of equal interest are questions relating to the broader issue of self-regulation. Is self-regulation in fact possible in franchising? Or is it, in itself, sufficient to address the problems and disputes that appear to have increased in franchising in recent years?

Testifying this morning will be a panel of very capable experts on franchising who will approach this issue and these questions from a variety of perspectives. I had hoped today's panel would have also included the current chairman of the International Franchise Association, Stephen Lynn, who could have offered the valuable perspective of a large franchisor, and at least one of the two former IFA chairmen who were also invited to appear today. Unfortunately, because of the lateness of our invitation, in part, and because of the demands of business and the many activities associated with the IFA's International Franchise Exposition later this week have precluded their appearance here today.

However, this is an issue the committee intends to pursue again in the future and we surely will provide additional opportunities to hear from these and other witnesses, and it is my understanding that they are also very desirous of testifying.

Let me emphasize once again the importance of the changed tone of the debate amongst franchisors and also of the initiatives being discussed today by franchisors. Whether these initiatives can bring greater balance and harmony to franchising, or whether additional private or public measures are necessary are questions we must continue to give broad public analysis to.

As I stated 2 years ago, I believe this is of vital importance that all parties in franchising join in meaningful discussion of ways to improve this vital business concept that is of such critical importance for small business development and for our Nation's economy.

[Chairman LaFalce's statement may be found in the appendix.]

Chairman LaFalce. I would like to call on the Ranking Minority Member, Mrs. Meyers, for any statement she might wish to make.

Mrs. Meyers. Thank you, Mr. Chairman.

I thank you for holding this hearing to protect unsuspecting franchise buyers from unprincipled sellers. I join you in welcoming all of our witnesses today, and because I am eager to hear their testimony I will offer only a few brief opening comments.

Let me begin by congratulating the franchisors and the franchisees who are helping them, for invigorating and extending their self-regulatory system. By energetically policing their own ranks, the franchise industry can address most of the disclosure and relationship problems that exist between franchisees and franchisors. Such self-regulation would allow the Federal Trade Commission and the various State authorities the opportunity to concentrate on the worst offenders, the few totally unscrupulous fly-by-night operators who prey on the unwary.

The processes and codes that define self-regulation are not all that stand between the aggrieved and those that they challenge. Self-regulation is only the first line of defense. Behind it stand the FTC and State enforcers, all of which are empowered to resolve differences, ensure a level playing field and to ferret out offenders and bring them to justice.

I still believe, however, that the private-sector solutions are preferable to Government mandates and bureaucracy. By working together, perhaps franchisees and franchisors can solve their differences and find equitable solutions to the natural tensions that private contractual arrangements inevitably produce.

As the Australian franchising task force concluded last year after an exhaustive study, and I quote, "The advantages of a self-regulatory code are that it is fundamentally industry or sector based, and minimizes the intervention of Government. The administrative costs and the policing and enforcement requirements are reduced. It provides a workable framework in which the franchising sector can grow and prosper."

I congratulate the International Franchise Association for instituting an alternative dispute resolution process based upon the Australian model to work out problems between franchisees and franchisors, if possible, without costly litigation and attorneys' fees.

As the program was just instituted in February, it is really too soon to measure the results. However, I think we ought to give this and the new code of ethics a chance to work before pushing forward with extensive new Federal regulation.

Of course, we should help protect those who may be naive from predators, but we should do so in ways that maximize potential and profits and not ways that stifle the growth and opportunity that so many small business persons have enjoyed as franchisees.

Again, thank you, Mr. Chairman, for holding this hearing, and I look forward to working with you on this and other topics affecting our Nation's small business community.

Chairman LAFALCE. Thank you.

Any other Members have opening statements they might wish to make at this time?

Mrs. Clayton?

Mrs. CLAYTON. Mr. Chairman, I want to thank you also for having this hearing and the substance for which it is going to cover, which is very important to a number of persons in my district and in the country.

Mr. Chairman, I recently became aware of the severe difficulties of a number of individual franchisees who have been confronted with doing business with various chains throughout the service and retail industries. Newspaper accounts in The Wall Street Journal have effectively documented the specific cases in which small business entrepreneurs have been confronted with cases of discrimination and financial difficulties.

In many ways, we are caught in a dilemma where we want to see self-regulation succeed. However, we are concerned that is not the case, and we will urge that we consider what else we must do to make sure that it is.

We are told that self-regulation is an effective means by which to mitigate problems that may arise. I am not yet saying that is not the case, but I am saying it has not been effective to date.

However, we are faced with indications that franchising systems may be tainted with a shade of fraud. At the same time, we resist the temptation to impose unruly Federal regulation on franchising systems.

The losers involved in these problems are the thousands of people who are forced out of their businesses due to the financial reality involved in turning a profit. Many small investors are driven out of their franchises by unfair practices that they are subject to based upon the terms of their contract.

Finally, I am deeply concerned by the cases of business discrimination in which minorities are impelled to take franchises in low-income areas where operating costs are exorbitant and profits are small. In this context, my overall concern is that there is an imbalance in the legal relationship between the franchisor and the franchisee. That does not enable the due process or redress of their grievances all the time. There is an imbalance.

Again, I am grateful this problem is being addressed, so hopefully we can resolve it.

Chairman LAFALCE. Ms. Velazquez?

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

I would like to welcome the panel to the hearing today to investigate self-regulation of the franchise industry. Franchising has been a way for many Americans to gain a foothold in the small business industry. It has also been a means for facilitating community development in minority communities.

While these people must be aware of the possible downsides of starting a small business, they must also feel secure that their hard work and talent will pay off in future profits and success. Yet,

there are too many stories that indicate that franchising is a system strongly favoring the franchisor.

We must look for a way to ensure that those who are willing and able to open a franchise are protected from unfair practices.

I look forward to today's hearing with the hope that it will shed some light on the conflicts that exist between franchisee and franchisor. I look forward to everyone's testimony.

Thank you.

Chairman LaFalce. If there are no other opening statements, we will go to our panel. I think we have four excellent witnesses this morning. Our first one will be Mr. Gil Thurm, senior vice president and general counsel for the International Franchise Association, in Washington, DC.

Our second witness will be Mr. Michaael Garner. Mr. Garner is a franchise attorney with the law firm of Schnader, Harrison, Segal & Lewis in New York City. Most importantly, he serves as the editor of the Franchise Law Journal of the American Bar Association's Franchising Forum.

Following Mr. Garner we will hear from Mr. Harold Brown, a noted franchise attorney from Boston, Massachusetts. Mr. Brown authored what was, I understand, the very first legal textbook on franchising in 1969, and remains one of our country's leading authorities on franchising, as well as one of the most prolific writers on topics of franchise law.

Our final witness today happens to come from a county that I represent, although I don't think we have had the pleasure of meeting before. Mr. Stewart Dizak, President of Video Data Services, a national video-taping franchise system based in Pittsford, New York, just outside of Rochester.

Gentlemen, I thank you for your attendance. Some of you have had to go to great difficulty to rearrange your schedules to accommodate today's hearing. I especially thank you.

Let us begin. What we will do, if there is no objection, is we will put the entirety of all your testimony in the record as if it were read. Without objection, so ordered. You may feel free to either read your testimony or summarize it, so long as the summary would be no longer than the reading of it.

We will start with you, Mr. Thurm.

TESTIMONY OF GIL THURM, SENIOR VICE PRESIDENT AND CHIEF COUNSEL, INTERNATIONAL FRANCHISE ASSOCIATION

Mr. Thurm. Thank you, Mr. Chairman, members of the committee.

I am Gil Thurm. I am the Senior Vice President and Chief Counsel of the International Franchise Association.

IFA Chairman Steve Lynn asked me to thank you for inviting him to testify, and he does look forward to an opportunity to appear before this committee at a later time. I appreciate this opportunity to appear here today on behalf of IFA.

The International Franchise Association is a trade association which serves as the voice of franchising. IFA is a resource center for both current and prospective franchisors and franchisees, as well as for the Government and the media.

Mr. Lynn, who is chairman of the board and CEO of Sonic Corporation, recently stated that his goal as IFA chairman is to make this a year of building bridges. Mr. Lynn stated: "I have witnessed firsthand that cooperation, consensus and compromise are key components of a successful organization. It is my wish to begin to build a bridge between the franchisor community and our customers, the franchisees. Cooperation between these two groups is not a sweet sentiment—it is an economic necessity to the future of franchising."

The Nation's franchised businesses account for over one-third of all retail sales—$758 billion—and employ more than 7 million people. While other sectors of the American economy have been shrinking in recent years, franchising has been expanding.

Chairman LaFalce. I just want to stop you there. I think it is important that we all digest that fact. Those who have been to our hearings before realize it, but again, we are now talking about an industry that accounts for over one-third of all retail sales, and employs 7 million people.

Please proceed.

Mr. Thurm. Thank you, Mr. Chairman.

This industry also has created more than 18,500 new businesses last year, which added more than 100,000 new jobs to the economy. We must seek ways to stimulate the growth of franchising, not stifle it.

Chairman Lynn also stated, as a part of his remarks at IFA's 33rd Annual International Convention earlier this year, "The theme of my chairmanship is Growth Through Unity. Franchisee and franchisor working together: Working together for success, working together to find better ways to bring high quality products and services to the marketplace; working together to head off potentially harmful influences such as outside regulation and legislation; and working together to protect the future of franchising and to lay the groundwork for franchising to play an important role in our economic growth well into the next century."

To achieve this desirable result, IFA began by creating more meaningful dialog between franchisees and franchisors. To this end, the IFA Board of Directors voted to create a Franchisee Advisory Council.

This council has three goals: To promote the concept of franchising as a mutually beneficial relationship between franchisees and franchisors within the IFA; to seek constructive ways to solve disputes between franchisees and franchisors; and third, to explore ways to increase the participation of franchisees within the IFA.

The Franchisee Advisory Council is only a first step. Our next step is a move toward self-regulation. In that regard, IFA has established a Franchise Code of Ethics which sets standards of conduct by franchisors in dealings between franchisees and franchisors. The Franchisee Advisory Council has been asked to help us determine how this code will be enforced throughout our membership.

We realize, however, that just setting the rules will not prevent conflict. As Mr. Lynn pointed out at our recent convention, "the interdependent nature of franchising is fraught with the potential for conflict. So another critical objective for the coming year will be

to seek out ways of setting conflict to rest without resorting to litigation or legislation."

Accordingly, IFA and member companies have taken steps to provide the leadership and guidance for Alternative Dispute Resolution. We believe that a well-considered Dispute Resolution Program will serve not only to resolve conflicts in the early stages but also to foster an environment which will strengthen the franchise relationship. Building a spirit of cooperation and compromise is critical to the future of franchising.

In this regard, the Center for Public Resources, CPR, announced on February 8th that a group of major franchise companies have joined to create an alternative dispute resolution process to offer all franchisees and franchisors as a mediation vehicle to settle franchise disputes.

Called the National Franchise Mediation Program, this ADR process has been designed to resolve disputes between franchisees and franchisors quickly and cost-effectively through the CPR legal program.

The Center for Public Resources' Program is a not-for-profit alliance of 530 major corporations, leading law firms, prominent legal scholars and public institutions. Through the CPR panel of Distinguished Neutrals, business and public disputes involving more than $5 billion were successfully resolved through ADR in the 3-year period ending December 1992.

The founding members of the National Franchise Mediation Program include: Burger King Corporation, Dunkin' Donuts, Hardee's, Holiday Inn Worldwide, Jiffy Lube, McDonald's, Pizza Hut, Southland and Wendy's. Additional companies, Kentucky Fried Chicken and Taco Bell, have also committed to this important process.

CPR President James Henry said the ADR mediation process "offers a less time-consuming, less expensive, less antagonistic route to settle disputes than traditional court proceedings, with an opportunity to agree on solutions courts could not offer. ADR will help franchisors and franchisees preserve relationships and productivity, since both parties must be satisfied with the terms of the settlement of their disputes."

"With the National Franchise Mediation Program, franchisees and franchisors will be able to resolve disputes with the assistance of a qualified mediator nominated by CPR from a newly organized panel of franchise neutrals."

All founding group members have committed to participate in the next 2 years in a mediated dispute resolution process for any dispute with one of their franchisees not resolved through internal negotiations.

A mediator located in the franchisee's region will be jointly selected by the franchisee and franchisor involved in the dispute. Costs will be jointly shared by both parties to the dispute.

The National Franchise Mediation Program will be a voluntary and informal process. "A mediator has no power to impose a solution on the parties. Rather, mediators will assist parties in negotiating solutions that meet their interests and objectives."

Mediation can generally be concluded rapidly, at moderate cost. In this program, a time limit will be set, after which the parties

will be free to pursue other remedies, unless both agree to the contrary. If mediation fails, other options are not foreclosed.

In conclusion, Mr. Chairman, we believe that the various programs and initiatives described above are very important and positive first steps toward self-regulation in the franchising industry.

As Steve Lynn stated in accepting the role as IFA Chairman, "My promise is that 1993 be known as the year of inclusion, the year in which franchisees are recognized as a meaningful part of IFA, a year in which we celebrate the mutually beneficial aspect of our relationship, a year when franchisees and franchisors unite."

Mr. Chairman, Members of the committee, the International Franchise Association appreciates this opportunity to present its views and we look forward to continuing to work closely with you and the members of the committee. We would be pleased to respond to any questions the committee may have.

Thank you.

[Mr. Thurm's statement may be found in the appendix.]

Chairman LaFalce. Thank you.

We will hold our questions until all the panelists have had an opportunity to make their presentations. But just one thing I should have asked you at the beginning, what percentage of franchisors belong to IFA, roughly?

Mr. Thurm. The percentage of franchisors, I know it is a large percentage of the folks who are franchisors, and also, more importantly, even though there are some franchisors who are not members, the vast majority of all——

Chairman LaFalce. I was told about 25 percent of the franchisors belong to IFA. Is that a ball-park figure?

Mr. Thurm. I think the relevant figure is considerably higher, Mr. Chairman. I will be pleased to provide that information for the record.

Chairman LaFalce. If others have some idea, they can tell us later.

Mr. Thurm. It is a large percentage.

[The following information was subsequently received from Mr. Thurm.]

The International Franchise Association's 1992 Annual Report included the following information: "Membership in the International Franchise Association grew in 1992 to 956 members, including 150 new members, up from 929 members in 1991. IFA's membership is comprised of seven member categories. Full members/382 (40 percent); Associate Members/201 (21 percent); Subsidiary Members/71 (7.4 percent); Sister Associations/26 (2.7 percent); Educational Members/15 (1.6 percent); COMFAD Members/54 (5.6 percent); CFS Members/207 (21.7 percent); TOTAL 956." The more important consideration is not the percentage of franchisors who are members, but rather the percentage of franchising activity encompassed within our membership: approximately 70 percent of all franchised outlets are within the membership as are 95.5 percent of all major chains.

Chairman LaFalce. Our next witness is the editor of the American Bar Association's Franchising Law Journal, Mr. Garner.

TESTIMONY OF W. MICHAAEL GARNER, ATTORNEY, SCHNADER, HARRISON, SEGAL & LEWIS

Mr. Garner. Mr. Chairman, members of the committee, I appreciate this opportunity to talk today about self-regulation and fran-

chising. I will not be reading from my prepared remarks, but just hitting some highlights of them.

Chairman LaFalce. By the way, I know you put your prepared remarks together almost overnight. I thought they were excellent, very well organized, et cetera, so you need make no apology for them at all.

Mr. Garner. Thank you very much.

First I would like to say I applaud any efforts toward self-regulation in franchising by the IFA, by individual franchisors, by other groups. I think that this can go a long way toward resolving certain types of conflicts that arise in the franchisor-franchisee relationship.

I also want to state there are many franchisors out there who have the attitude and the capacity to resolve disputes within their own system. But that is not a universal phenomenon. Problems remain in franchising. They are not limited to the unscrupulous or the fly-by-night operators. For reasons I will touch on in a moment, I do not think that self-regulation is the answer at this point.

Let me give you a few examples of problems that have arisen in the disclosure area. Last week when I received the committee's invitation, I was trying a case in which a franchisee of the Hardee's chain had purchased a franchise on the basis of the franchisor's representations that it could purchase company-owned stores and on the franchisor's disclosure of the prospective earnings of a particular location that was not in accordance with the terms of the FTC rule.

At the trial, the area vice president of Hardee's admitted that the disclosure of that information was against Hardee's policies, was possibly against the law, that he was unaware that his subordinates had given out this information over a period of some 10 months, and that he had no enforcement mechanisms to enforce the company's own policies.

We haven't had a verdict in that case yet. But Hardee's, in approaching that litigation, really didn't dispute the disclosure of the earnings claims. They simply took the position at trial, which is correct on the law, that there was no private remedy for that. The earnings claims, by the way, were over $200,000 overstated. The franchisee is important——

Chairman LaFalce. It is important that you reiterate that statement. They argued and the judge accepted as a matter of law that, whether under State law or Federal law, there was no private remedy; is that correct?

Mr. Garner. There was no private remedy for the disclosure of the earnings claim, and in fact we don't know the result yet, but we had an uphill battle with the judge in arguing that the FTC rule provided a standard for disclosure that could be applied in a common law context.

What is significant about this case is that one of my clients, an investor, is a lawyer in private practice. He has been in private practice for 25 years. He mediates disputes as a way of making his living. He is known in the community as a mediator.

He approached Hardee's on two occasions, visiting their headquarters, to try to reach a business solution to this problem. Har-

dee's would not listen. They have decided instead to proceed with litigation.

I cite this as an example of an attempt in the private context with a private company to resolve a dispute that failed, and that ultimately went to litigation.

Let me give you another example. The Reids, a family in Florida who purchased an All Tune & Lube franchise, believed they had been defrauded by the franchisor and there had been errors in the site selection for their franchise. They went to the IFA with their complaint. The IFA assured them that their complaint would be held in confidence, and that an investigation would be made.

Then they learned that the IFA had turned over their complaint to IFA's counsel, who also happened to be the franchisor's counsel.

Later, they were informed that IFA's board was going to take up their complaint. They wrote to IFA to find out what the status of it was. They never got a written response.

Today, no one can tell the Reids what the status of their complaint with IFA is. I cite this as an example of attempted self-regulation by IFA. I realize it is not in the context of the new proposals, but here is something which was a fairly simple complaint, looks like it was bungled.

Finally, let me cite the example of Mr. Sign, a franchisor that made a number of fraudulent statements in its offering circular, including the assertion there was no material litigation, when in fact there was a complaint on file for violation of the New York State Franchise Sales Act, as well as a complaint for securities fraud. There were some, over 70 franchisees in the Mr. Sign system when Mr. Sign went down the tubes in 1990.

Those franchisees went to both State regulators and to the FTC. Their complaints fell on deaf ears.

One of the groups I represent have been able to prosecute a private action against the franchisor, its officers and former directors. They have invested in the six figures in that private lawsuit. That is a remedy that is not available to most franchisees.

The point I want to make here is that this is an example of where regulation, current regulation at the State and Federal level has been ineffective to redress the complete collapse of a franchise system.

I wish I had time to tell you about the other franchisees that have come to me from time to time with complaints about their franchisors that I have been unable to help because they couldn't pay the freight. I am in private practice, and those complaints to State and Federal regulators have fallen on deaf ears.

I have cited a couple of disclosure problems. I think there are problems in the industry with respect to ongoing support in particular.

Chairman LaFalce. Everything you have mentioned so far has to deal with the subjects of disclosure. You are now going to a separate subject, correct?

Mr. Garner. Separate issue, which is the franchisors' capacity to provide ongoing support to franchisees.

There is a major franchisor engaged in the auto repair business that for whatever reasons over the last 3 to 5 years has been unable to send people out into the field regularly to consult with

franchisees. The franchisees thought that they were getting a state-of-the-art system that would be maintained regularly and updated so that they would be able to provide their customers with state-of-the-art services. The franchisor has been unable to do that.

There are now several lawsuits, if not dozens, pending against the franchisor in connection with that.

Another major Fortune 500 corporation thought it would be a good idea to get into the franchising business, so they went out and hired a bunch of franchise executives from other franchisors. They learned that their system didn't do everything that they thought it could do. They ended up handing over their training and ongoing support functions to one of their franchisees, who was in fact more experienced in the area than they were. They are now talking about selling the system to one of their franchisees.

Mr. Chairman, you asked what changes are needed in franchising to address these types of problems. I think that what is needed is a change in attitude more than anything else.

What I see in my practice in some instances, in the instances where there are problems, are attitudes by franchisors that they can do no wrong. If they have complied with the minimal disclosure requirements, well, the compliance is complete, there is no private remedy under the FTC act, too bad if the business fails.

Franchisors, I think, need to adopt an attitude——

Chairman LaFalce. I want to make sure all the Members understand what you said. Although there is an FTC disclosure rule, there is no private remedy automatically available under that Federal law for it. It must be enforced exclusively by the FTC. Or if there is a State little FTC act, there might be a private remedy in that State. Most States don't have little FTC acts.

Mr. Garner. I think it is important to emphasize in that regard that the FTC rule, for example, on earnings claims, is a broad prophylactic rule that says, "Thou shalt not make earnings claims disclosures unless you comply fully with the rule."

It is a rule that does away with the requirements that you have, say in a common law fraud context where you have to prove intent to defraud, you have to prove that the earnings claim was false, known to be false when it was made. There is a purpose in that broad prophylactic rule, which is to prevent the possibility of misrepresentation to franchisees.

The fact that franchisees cannot go into court and prosecute an action on the basis of that rule means that they are faced with proving a common law fraud claim which is far more difficult to prove.

I don't think that self-regulation, certainly at this point, is a remedy that can work to alleviate these problems. First of all, we have the question of who is going to do this.

Let's assume that IFA successfully launches its alternative dispute resolution program. Well, I don't know what the number is, Mr. Chairman, of how many companies are out there that are not members of the IFA, but all you have to do is visit a local newsstand and pick up one of the directories of franchise opportunities, and you will find scads of names that are not IFA members.

This is particularly significant because I think that many abuses do occur with startup companies. Maybe they don't even know the

IFA exists, but there is no way that IFA is going to be able to police them.

Assuming that there is some kind of alternative dispute resolution or some type of self-regulation, even within the scope of that self-regulation you have the question of what sanctions are going to be imposed. I haven't seen anything that tells me what the sanctions are.

I don't think expulsion from an industry body is going to be meaningful to a franchisor. I am not sure you are going to see an alternative dispute resolution panel inclined to award treble damages to a franchisee. What you will see is an effort to compromise.

Another question I have about self-regulation is whether it will simply be another hurdle for an aggrieved franchisee to surmount in an effort to obtain redress from a franchisor.

I think there is a role for self-regulation today. I think it is really as an early-warning device. Sometimes if a problem can be identified at its outset, there can be mediation to resolve it.

I will go back to the Hardee's example and see that if there had been a sincere effort on the part of the franchisor to look at that as a business problem and to work toward a business solution, there would not have been a lawsuit.

But self-regulation, I have serious doubts as to whether it can remedy problems that have blossomed into a full disaster.

In closing, I do want to say that I think that Federal legislation is needed. I think it is needed to the extent that a private right of action ought to be provided for violations of the FTC rule.

I think that there should be some type of duty of competence, even though it may be a low threshold of competence, unless the franchisor holds itself out as having some greater level of competence.

I think there should be a national standard for termination and renewal and transfers of a franchise. I think this committee can look to the Petroleum Marketing Practices Act as an example where relationship legislation, at least to my knowledge, has been very successful in the oil industry, which is one of the branches of franchising.

Chairman LaFalce. The automobile dealers, too.

Mr. Garner. And automobile dealers as well. Particularly at the State level, where there are very extensive relationship statutes.

Thank you.

[Mr. Garner's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much.

Our next witness I believe is the first author of textbook law in franchising, Mr. Harold Brown of Boston, Massachusetts.

TESTIMONY OF HAROLD BROWN, FRANCHISE AUTHOR AND ATTORNEY

Mr. Brown. Thank you very much, Mr. Chairman.

I am truly thrilled to see the activity of this committee and to participate in some little fashion, if I can.

In a way I have to say to Mike Garner, a competing author by the way, he has got a fine book on franchising——

Chairman LaFalce. Look at the two of you. I suspect yours preceded his.

Mr. Brown. I cannot disagree with anything that he has told you. Instead of reading my statement, which is there for you to see, I wonder whether I might add a few observations that will help you to go forward.

Let me give you the benefit of the result of 55 years of active litigation experience that I have, aside from the 30 years in franchising, my area of concentration. This is not an academic statement. It is fact.

Settlements of disputes are a coefficient of the effective assembling of facts of creditable law, and the vigorous pursuit of legal remedies. Now, that formula is immutable, and I hate to tell you this, it is perfect.

One cannot mediate unless there is something strong in the way of substantive law or the elimination of procedural abuse or when one party knows that the other party is going to be helpless or semi-helpless.

Let me repeat it quickly. Effective settlements are a coefficient of the effective assembling of facts and of creditable law and the vigorous pursuit of legal remedies. That is an absolute necessity.

Rather than go to my remarks again, I am going to add a fact story such as Mike Garner gave you, because it occurred so recently at the meeting of the franchise committee of the American Bar Association's section of antitrust law where I had the opportunity to meet Mr. Thurm for the first time, and he mentioned the IFA code of ethics.

We were allowed to pick to each other publicly, and I said to him, the same as Mike has said, "Who is formulating the rules, who is conducting the sessions, and what happens?" He said, "Harold, I am new at this, I have just taken on this, I don't really know."

I said, "Let me give you a case to worry about," and that is the case I am going to tell you about right now. I am sorry I have to name names, but these cases are meaningless without the naming of the names.

Cajun Joe is a franchise that had at one time as many as 155 franchisees, of whom over 100 have failed. Over 100. I think it is 125, but I can't keep track of them.

That system is owned personally by Mr. Fred DeLuca and his partner—I think it is Peter Burns, I am not certain—who are also individually the owners of Subway. This is not a fly-by-night system that came into the arena. Subway has 7,500 franchisees. But we don't have to guess a lot about Subway either. We just need to read occasionally The Wall Street Journal and its interview with Mr. Fred DeLuca.

Now, these are his figures. I don't quote them with precision, I can't remember every one of the figures, but they are about right. He said, "About 15 percent of our franchisees have failed outright. Another group of about 30 to 40 percent, they barely manage to eat." When you say that, a franchisor means he, the franchisee, and his wife and their two teenage children work 6 to 7 days a week. That is what he means.

Then he said, "There are about 30 to 40 percent, that seem to be getting along. They can eat. About 15 to 20 percent are doing extremely well." That is not the 96 percent nonfailure rate that was given to you by the IFA.

Cajun Joe no longer sells franchises, so its 125 out of 155 failures are not noted anywhere. Subway is theoretically a separate company, because the same two individuals own all of the stock of both entities, and it makes no report about Cajun Joe's. Nor is its sorry record given to The Wall Street Journal by Mr. DeLuca. A proud record!

I asked Mr. Thurm, "What do you do with Fred DeLuca?" He said, "I don't even know him." I said, "Well, I will tell you, you put him on your board of directors." I fool you not.

We do need, as Mike has said to you, firm understanding of the laws. For example, franchisors universally state that good faith is nothing but honesty in fact and living according to the standards that prevail in the particular trade. I guess that means in Cajun Joe's, if you tell them how they are going to fail, you are being honest. That is not what franchising is. Franchising is a wonderful system. But the way that it is being done is wrong.

The Chairman mentioned automobiles. How about Mr. Soler, who lives in Puerto Rico. He has a Chrysler-Plymouth agency but he also has a Mitsubishi agency. He had difficulty with his franchisor. His franchise agreement says, "Thou shalt arbitrate all disputes at our home office, in our language."

Here is Mr. Soler in Puerto Rico, required to go to Japan and to arbitrate in Japanese before Japanese arbitrators. You may think that is a terrible, terrible arrangement. Who do you think compelled him to do it? The United States Supreme Court. That is their rule in Soler Chrysler-Plymouth versus Mitsubishi.

Think of what I have just said to you: 15,000 miles away to take his lawyers, his records, translate from Spanish—I think they speak Spanish there—to Japanese and Japanese to Spanish. That is not law. That is anarchy.

The automobile dealers don't fare any better because they have already been excepted from the FTC Disclosure Rule. Major refineries all sued the FTC for improper procedures, so the FTC said, wait a minute, wait a minute, and they excepted them all.

The records of failure therefore don't include the 200,000 to 240,000—I am not sure which—of gasoline service station franchisees who have been destroyed in the past 10 years in spite of the Petroleum Marketing Practices Act that was snuck through this legislature in the still of the night. Theoretically, it provided some protection but it provided none, because it allowed the major refineries to withdraw from the marketplace: 240,000—that is, 98 percent of them—independent gasoline service stations were destroyed.

How about the 500 to 1,000 truck, automobile and equipment dealers who annually go under? Who would have the chutzpah—I am Jewish, I love the word chutzpah—who would have the chutzpah to say there is a 96 percent rate of success in franchising when we have figures like these?

How about Snap On Tools and Mac Tools, both owned by triple A companies listed on the New York Stock Exchange, who for 10 years have claimed their dealers are not franchises?

If I go too far, Mr. Chairman, please stop me. Just let me tell you this one story. They were careful. Right after the FTC rule became effective on October 21, 1979, Snap On Tools wrote to the FTC, gave them all the facts and said, we don't think we have to comply with your disclosure rule. The FTC said, on the facts you have given us, you are right.

So there was no disclosure of the hundreds of franchisees who lost all their money, lost all their money. Believe me, they lost all their money. But in 1990, a letter came from the FTC to Snap On, stating "On the facts that we now know, you misled us. You are, and have been, a franchisor all along." Their only defense was supposedly that they hadn't required their dealers to pay $500 within the first 6 months of the start of the arrangement.

That $500 payment is one of the standards that was thrown in as a matter of administration. It has nothing to do with whether you are a franchisee or a dealer.

The fact is that Snap On lied when it wrote to the FTC in 1979. There was a requirement of far more than $500 to be paid in the first 6 months. It was indirect, but it was there.

Now, are we making believe? No. I have to give you this account of the Snap On litigation record. The first lawsuit was in 1985, in San Francisco. The Snap On dealer recovered $5 million in punitive damages in a jury verdict, and then the franchisor settled. A few months later in 1986, another Snap On franchisee recovered in Portland, Oregon. He was awarded $9 million in punitive damage recovery, and again Snap On settled. In between that and 1992, there have been dozens, hundreds of cases against Snap On.

One of the most pitiful cases of all was the franchisee in Honolulu, a holder of two college degrees. He examined what was going on and at the end of 6 weeks said—just 6 weeks a franchisee—"It is mathematically impossible for me to succeed." He then committed suicide.

So we asked. We found out a half a dozen other dealers committed suicide. Now, that is the Snap On. Now we come right up to 1992 when a jury in Raleigh, North Carolina, on behalf of four Snap On franchisees—who weren't franchises, according to Snap On—makes a finding of $500,000 for each of them and $5 million in punitive damages.

Now, mind you, punitive damages are supposed to be punishment and deterrent against repetition. But from 1985 to 1992 there were hundreds of failures that were favorably litigated. There was not a single record of any of those failures anywhere because Snap On said it was exempt. Compare that record with the 96 percent failure figure you have been given by the IFA.

Well, Snap On gave up the ghost On January 1, 1991, and decided to become a franchisor, legitimately to come out of the closet, so to speak, and they have now registered and they are now making disclosure, but no disclosure of any of those hundreds of court and arbitration decisions that they lost. Of course, they now state they were "settled."

I am prejudiced. I am handling 41 of those cases: One lawyer. I know of another lawyer with 56 Snap On cases. I know of another with 14 of them.

While this was going on, Snap On was making $100 million a year in net profit. We are not talking about a little piker here. It adamantly and falsely claimed, "Not a franchisor. Not included. No FTC rule." No disclosures, in spite of their false earning representations to each franchise. A wonderful judge in northern Idaho said, "I don't care whether Mac Tools is a franchisor or not. They are liable for $50,000 in compensatory damages to this franchisee, and $500,000 in punitive damages." That was a 1992 decision.

Mac Tools had the identical system created by Snap On Tools. Mac Tools is owned, I think, by Stanley or some huge company. Both companies simply defied all of the relevant laws.

Let me get back to, if I may, to the IFA Code of Ethics. The other things are all in my written statement. I guess I have spoken too long.

Chairman LaFalce. Don't omit your opening paragraph, please.

Mr. Brown. All right, I will do that. 1970, the Federal Trade Commission started its hearings as to whether or not to adopt a rule that now exists. The IFA promptly adopted a supposedly ethical rule.

Chairman LaFalce. I was thinking of a different opening paragraph, in your oral opening statement. But that is OK. Proceed as you wish.

Mr. Brown. They adopted a code of ethics in 1970. They said, "Let's have self-regulation. Let's try it our way." By the way, it wasn't a bad code of ethics, if you looked only at the code itself.

Then IFA said, "Don't have conduct regulation. We will get along with disclosure." That was a sort of dichotomy. But in any case, the IFA played the game for 10 years until the FTC finally adopted its Pre Sale Disclosure Rule, effective October 21, 1979. As you know, it had no private cause of action, and as your Chairman has said, only a sparse amount of enforcement.

Is there a reason why people, good American citizens, shouldn't all have access to the same legal rights? Why should only the citizens of a dozen States be able to enforce the FTC rule against franchisors?

This committee is doing a very, very valuable service. I think it may have intended it, but if it didn't, just as good, take credit for it.

Chairman LaFalce. We intended it.

Mr. Brown. As a direct result of your promotion, there has been a recent surge in State legislation. The 1992 Iowa conduct statute is a landmark in this country. Almost all the franchisee associations fought for the bill, while the IFA was bitterly and extensively opposed. The IFA almost made it. The vote was 20 to 1 in favor of the statute.

At the last meeting of the IFA legal seminar, its general counsel said, "Those franchisees spent over $100,000 in lobbying to get the Iowa act passed." Well, isn't that terrible?

I attest here and challenge the IFA to deny that it has spent $5- to $10-, maybe $15 million in lobbying in State legislatures, Federal

legislatures, both through PAC's and in every other fashion that you can imagine. It is the way they claim that system works.

Those franchise associations put together $100,000 and they got the bill through. But now look at what is happening. In 1993, similar bills have been introduced in South Dakota—and we deeply, deeply regret the untoward death of their Governor 2 days ago—as well as in Texas and in Arkansas. The Arkansas procedural fairness bill requires litigation in the franchisee's State and under laws of the franchisee's State. None of this fancy language. It carefully states that it is intended to state "fundamental public policy" and "intended to be applied to existing dealers," thereby overcoming what I call the forlorn attack on the Iowa law, because it is supposedly retroactive. That is not a good legal attack. We are talking about conduct, not contracts, anyway.

Chairman LaFalce. Mr. Brown, I don't mean to interrupt you, but I wonder if you can summarize the rest of your remarks and bring it to a conclusion so we can go on to the next witness and have questions for the panel.

Mr. Brown. To illustrate how bad the IFA code really is, I am going to jump to the provision in the ethical rule having to do with encroachment, which is a very serious factor. In the IFA proposed code, now an adopted ethical code, they state that a franchisor is allowed to take into account 12 standards. I suggest to you that you read them. I can't understand them. I don't understand what they mean.

I suggest you look at them and find that if they mean anything, they mean that a franchisor can with impunity ignore the code, ignore any threat that any chastisement or sanction or anything may set against them, and may just do whatever they want with unlimited encroachment, even enough to wipe out the franchisee.

The very terms of the instrument that is being suggested here as possibly a means to get somewhere are false on their face. I gave you my judgment. I could write another 45-page article on that issue, and I may do so. But I am telling you, please look at the terms of the IFA ethical code. Every single one of the standards has a "phony" in it. But the one on encroachment has 12 "phonies." Please look at the list.

Thank you very much.

[Mr. Brown's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Brown.

Mr. Mfume. Mr. Chairman, I have a point of order. The gentleman has just referenced a document that I don't know if members of the committee have or have seen, and as such, that it might embellish his own remarks.

Could I ask unanimous consent that that document, that ethical code, be made part of these proceedings if it has not been?

Chairman LaFalce. I think it is an appendix to your testimony, is it, Mr. Thurm, or easily can be?

Mr. Thurm. It can be, absolutely, Mr. Chairman.

Chairman LaFalce. We will do that.

[Mr. Thurm's supplemental submission may be found in the appendix.]

Chairman LaFalce. Our next witness, Mr. Dizak, will tell us he started out as a franchisee but now is a franchisor with approximately 250 franchisees. Is that correct?

TESTIMONY OF STUART J. DIZAK, PRESIDENT, VIDEO DATA SERVICES

Mr. Dizak. That is correct.

Mr. Chairman and members of the committee, I am not an attorney by far. I am not as good a speaker as my predecessors are. I fully concur with Mr. Garner and Mr. Brown. I am not going to put it quite as elegantly as they did, but I am going to put it in layman's terms.

First of all, addressing a couple of factors mentioned as far as 25 percent of franchisors being a member of IFA. From my previous experience, within 2 or 3 percent, that figure is correct. You can simplify it out by going and buying any franchisor directory and buying an IFA directory, and see what the percentage or what the number is.

I also feel that there is an inordinate amount of abuse by franchisors far and above what has been mentioned so far.

The other thing, I was a member at one stage of the IFA, and in the literature, it mentioned IFA represents franchising. I think it is an incorrect term. The IFA represents franchisors, and I think that should be made clear. It does not represent franchising, as that would infer that it also represents franchisees.

I would like to get to my actual testimony. I am not going to go through the whole thing word by word, but I would like to highlight some special phrases.

I come before you, again, with the unique perspective of having been both a franchisee and now a franchisor. I have also brought with me a franchisee, Bob Muller, a franchisee in our Washington, DC area, and has been with us for several years. Bob is quite experienced and very successful as well.

Approximately 2 weeks ago our company had an annual convention in Washington, DC. Bob hosted it, coordinated the entire convention, and the evening prior to the convention held a session, and he planned and ran it on his own accord for all the affiliates, as we call them, who have joined us in the last 2 years.

In fact, Bob knows virtually every one of our affiliates' franchisees that have joined our company since the time he joined about 5 years ago. You are free to ask him any questions, either before, during or whatever.

My personal experience with franchising began in 1980 when I purchased a video rental store from Video Connection of New York. This was after I had sold a previous business I was in for 10 years. I was a copy machine dealer.

As part of the sales pitch to convince me to buy the franchise, the president of Video Connection personally informed me that with an investment of $25,000 I should be able to net a minimum of $50,000 for the first year and $100,000 or more thereafter.

I did review the disclosure documents with my attorney. He made some changes but didn't find anything materially wrong. As a result, I did buy a franchise.

At the time of my grand opening, only half of my initial merchandise showed up and none of the personnel or promotional material were there. Within 6 months, as a result, I closed the business down with a loss in excess of $50,000. I then moved—the business was opened in Sarasota, Florida. I moved back to Rochester, New York.

One of the most important factors I would like to bring up next, I discussed at this time taking legal action with my attorney, but he advised me that the only damages I could sue for was a return of the initial franchise fee, and even if I won, it would probably cost me more time and money than it would be worth.

Most franchisors realize that. There are examples here. They realize that. They figure the franchisee is not going to have the wherewithal to go after them, so they can get away with murder. That is essentially what happened in my situation. My attorney told me to forget it. Even if I won, I lose. So I chalked up my losses and went on.

Prior to starting Video Data Services, I should say when I was in Sarasota, Florida with this video rental store, I did see the potential positive side of franchising as well as get the idea for my own franchise business, going into video production. But prior to starting Video Data Services, I started a market survey of franchising.

I began by contacting several successful franchisees in various fields to find out what they like most and what they like least about franchising and what the relationships were with their franchisor. They indicated what they liked most was the franchisor's name, and in some cases there was a fair amount of support.

What they liked the least by far was the royalty percentage that they had to pay the franchisor. They felt the growth of their business was due more to their own efforts rather than the franchisor, and they disliked having to pay an increased dollar amount to the franchisor as a result of their own efforts.

The second complaint was misinformation contained in the franchisor's recruitment literature. They went on to say that they could not understand the disclosure documentation, and in most cases it was one sided. Some franchisees also complained about insufficient follow-ups and support from the franchisor.

As a result of the above information, I decided first and foremost in my business I would provide support beyond the expectation of the franchisees. I would also have the franchise designed so the individual could start on a part-time basis without taking a risk of giving up his full-time position. Then when the business was built up sufficiently, then go to full time.

Another major change, instead of charging a royalty percentage of gross sales, I decided to simply charge a flat amount of only $500 per year. This might sound ridiculously low, but in the long term it did turn out to be a wise decision as it paid off in other ways. In fact, this is probably the number one reason why our firm has probably the highest satisfaction in the franchise industry, or amongst the highest.

Before I proceed any further, I should mention the flat-fee amount would not work obviously for a large franchisor like McDonald's where there is a tremendous amount of support.

In addition, my experience is based on smaller franchisors, those franchises selling for less than $100,000. This also appears from my point of view where most of the abuses are occurring.

In return for a low fee per year, instead of royalty percentage, we asked our affiliates once they are established to assist the new affiliates coming after them with both marketing and technical support. Our affiliates also act as our sales force. We do not use outside sales representatives since we feel our existing affiliates have far more credibility and will not inflate expectations.

Advantage of using our affiliates instead of using outside sales representatives—in other words, they tell it like it is, both good and bad. It actually adds to our credibility if there are some negative comments, because nothing can ever be a hundred percent positive or good.

Another major factor which is another real problem in franchising, and another reason for the success of our firm is that we promote communications amongst our affiliates.

I have found that the majority of franchisors try to keep their franchisees in the dark and discourage them from communicating with each other. We do the exact opposite. A good portion of our monthly newsletters put together by our affiliates and our annual convention is also planned and organized by our affiliates who volunteer their own time to do so.

Last month our company held its annual convention in Washington, DC. We invited Robert L. Perry to be our guest, who is well-known in the franchise industry and author of the book, "The 50 Best Franchises." At the convention he had the opportunity to speak with many of our affiliates of his own choosing. After doing so, he asked if he could be allowed to make a brief presentation.

He stated that Video Data Services was the most open, welcoming team he had ever seen in franchising. He went on to say he had never seen a group work as well together.

His last comment that the Video Data Services was the ideal that franchisors should strive to be. After that comment, I felt that my own business philosophy was confirmed, and I realized that I accomplished what franchising should be.

I would now like to address my point of view regarding the proposed new disclosure documentation as well as self-regulation.

First of all, a lot of people will not agree with this comment, but I am going to make it anyway. Why does a firm want to franchise? My answer to that is, to get an increasing cut of someone else's work efforts forever. That is essentially the main advantage to a franchisor. I'm not saying it is good or bad, but it is the main advantage to the franchisor.

Franchising started out with a negative connotation. However, firms such as Holiday Inn, McDonald's and Burger King turned the franchising into the good name that it had until recently.

The changes I feel are necessary to return franchising to respectability are, number one, regardless of additions and disclosure documentation, new regulations, everything else, above and beyond that has to be simplification in the language of the franchise disclosure so somebody can understand it.

Our firm's franchise disclosure documentation is relatively simple, yet we still have attorneys calling us asking to us explain

the various terminology. Furthermore, in examining other disclosures, it appears they are purposely written so as to be as totally one-sided and confusing as possible. If an attorney cannot decipher disclosing documentation, how is the average layman going to?

Someone who is buying a six figure or higher cost franchise with as well, normally have the business expertise and legal support for due diligence. However, a franchisee spending below $100,000 is in most cases investing his or her life savings and in a lot of cases not even contacting an attorney. Maybe they should, but they don't. They have to go strictly by what they can interpret from disclosure documentation.

Now, I would like to refer to something that is not in here. There was an article in the Rochester Business Journal on April 2, 1993, "Both Sides of the Industry Question LaFalce Franchising Legislation." As part of the article, the reporter, Michael Cosgrove, approached an individual in Rochester by the name of Larry Kessler. Larry Kessler is a friend of mine who owns 20 Burger King franchises in the Rochester area. However, Mr. Kessler spoke from the point of view of the franchisor in saying, We don't have an obligation to protect the foolish.

There have been several comments in the press and articles, comments from franchisors, indicating that if someone is stupid, it is not the Government's responsibility to protect them.

Well, ladies and gentlemen, I am one of those stupid people, because I don't understand the franchise disclosure documentation for the most part, even with my experience. Again, I considered myself pretty well versed before I bought a franchise. Apparently I was not well versed. I considered myself fairly intelligent, but I am not—I am one of those stupid people.

In any new disclosure documentation, I feel the boldest print on the cover should state, "Any earnings claimed or other statement made to you by the franchisor is meaningless unless it is backed up in the disclosure documentation."

As far as self-regulation, I am not aware of any industry self-regulating groups that can be an example for franchising. In fact, I have never seen any organization capable of self-regulating itself, and I doubt any individual here has. I consider myself a very fair individual, but if I am self-regulating, I am still going to look out for my own interests first.

A good example of how self-regulation cannot work—and again I will refer to a couple of Mr. Brown's comments—the International Franchise Association has large franchise shows scheduled this weekend in Washington, DC. The advertisement on TV and in print, which I have in front of me, claims the success rate in franchising is 94 percent and the average franchisee earns $124,000 net before taxes.

This statement is utterly preposterous. If this were true, this hearing wouldn't be here, because the individuals here would be out running their own franchise businesses.

In the last 2 weeks, I have contacted over 20 franchisees of such well-known franchisors in western New York such as Mailboxes, Subway shops, and others. Their average earnings were approximately $36,000. This included some very successful operations

which may have tilted the figure to a higher amount than what it would have been otherwise.

I strongly question the sources used by the Gallup poll that provided the 94 percent success rate and the $124,000 income. If one watches the visual backgrounds, you will see on display the logos of the largest franchisors in the United States. That refers to who the Gallup poll contacted, perhaps. But how can an association self-regulate that takes that attitude and gives such preposterous figures?

One of the biggest problems is unrealistic earnings claims.

Chairman LaFalce. Mr. Dizak, because of time I am going to ask you to try to conclude your remarks in the next 2 or 3 minutes or so.

Mr. Dizak. I should comment, I would like to relate a recent conversation I had with the advertising rep of a major business opportunity magazine. I called him to complain that even though their advertising rates have gone up considerably, the amount of leads we have received from advertising in their magazine has dropped in over half in the last 12 months.

I am also told the number of sales has dropped considerably, I said the first time in our history the number of sales have gone down in the previous year. He said, Stewart, you should be happy. Most of the advertisers are indicating a 40 to 50 percent decrease in sales from last year.

One can make several conclusions from that statement. The economy, the negative image the press has generated on franchises as of date, the general public is becoming more careful in investing in franchising and business opportunities.

I would rather doubt that the larger established franchisors would take strong exception to new disclosure documentation. Some of the smaller ones will, because if the new disclosures go into effect, you are probably very shortly thereafter see it decrease in about 20 percent of the franchisors.

I will close my presentation by adding that if franchisors would look upon their franchisees as partners rather than someone to simply make money off of, in the long term they would both be far more successful. For the franchise to succeed, both franchisor and franchisee must mutually benefit.

Thank you.

[Mr. Dizak's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much.

This has been an excellent panel.

I will try to limit my questions to no more than 5 minutes, and I will ask all Members to do the same.

I would like to posit this situation. The best possible disclosure in the world, and the best possible understanding between franchisor and franchisees, informal though it may be, which creates a good working relationship, in fact good-faith dealings with each other, et cetera. Let's say that has existed in Mr. Dizak's situation as a franchisor with his 250 franchisees. What happens when Mr. Dizak sells out?

Let's say he owns his franchise system 100 percent, 100 percent interest in his franchise. What happens when he sells out and all of a sudden the person or the entity, the new corporate parent, whether within the United States or in England or in Japan,

doesn't want to proceed the same way in this partnership arrangement. If there is no contractual or legal duty, where does this leave these 250 franchisees or 2,500 franchisees who may have invested the totality of their life's worth based upon their knowledge that they were dealing with a good person and a good firm? Where does it leave them?

Anybody want to comment on that?

Mr. DIZAK. I can address that. Mr. Chairman, first of all, if a franchisor is successful, there are normally willing buyers willing to buy the company, or people working for the franchisor who are willing to take it over in some kind of buy-out program. So if it is an ongoing, successful business, that is not a problem. If it is not successful or not a legitimate business, there is a problem.

In our particular case, we have made arrangements to have some of our franchisees' affiliates take over.

Chairman LAFALCE. You are missing my point. My point is, if somebody wants to buy the franchise system, I am talking about the franchisees, where does that leave the franchisees?

Mr. DIZAK. At the mercy of whoever buys it.

Mr. BROWN. It is worse than leaving them at their mercy. The trend of most of the litigation is that where the acquisition is made by a purchase of assets, that there is absolutely no liability even though the new owner continues to reap the benefits.

One of the suggestions that I have made to this committee addresses that, suggesting that anybody who buys a franchise and then continues with that franchise assumes those obligations.

Curiously enough, there is good legal background for that in the State of Massachusetts, where that is called a "novation in the circumstances." It is a very interesting concept. The new owner becomes obligated under the old transaction, even though he hasn't signed an assumption.

But there are other things. Diet Systems, with 41,000 franchisees, acquired by a multi-billion dollar group, headed by Thomas Lee in Brookline, Massachusetts, and what did he do when he took over. Because he overpaid, he increased the franchise fees 41 percent. This was in a somewhat highly challenged industry.

They immediately brought lawsuits all over the United States, one in Idaho too, as a matter of fact, San Francisco, and they forced Mr. Lee to reduce that ridiculous increase at a time of such a distressed situation. But certainly that happens, and the franchisees of the surviving entity can have an extremely difficult position. I think that is what you were asking about.

Chairman LAFALCE. Yes. I think we can give countless examples of that.

Mr. Thurm?

Mr. THURM. Mr. Chairman, I would just add, in the real world I guess there would be little reason for the acquiring company to want to do anything that would hurt or alter or downgrade the effectiveness of this enterprise he just purchased. So in the real world those situations may work out very well.

Chairman LAFALCE. I think a good many real-world situations could be given, Mr. Thurm, where it hasn't worked out very well, where there has been a totally different change in the relationship, in the support system, in the concept of the duty to extend a life-

line to the franchisee, where there has been a different marketing plan, where there has been a greater need for capital or where they have to do something that affects the bottom line immediately, where they decide let's immediately open up a great many more franchisees than we have the capacity to support, et cetera. It could have a profound change.

Mr. Thurm, did you have any comments on Mr. Dizak's statement that this advertising that is apparently—I haven't seen it—that is taking place now regarding 94 percent success rate and $124,000 average profit, is that what—what does the ad say? What do you say of Mr. Dizak's claim that it is absolutely preposterous?

Mr. THURM. Mr. Chairman, I know that both you and your staff have had some concerns over some of the statistics that have been compiled for the franchise industry, and I think that those ads, although I have not seen them, are reflecting the surveys that have been taken, Gallup polls, commissioned surveys, picking up information from a variety of sources, Arthur Andersen studies. I will provide for the record the surveys that relate to that figure.

Chairman LAFALCE. I know there has been dispute about the 94 percent. Mr. Brown and Mr. Dizak think it is way off the mark.

What about this $124,000 average earnings or average profit? I mean, what does it say? First of all, what is in the advertising? Do we have that?

Mr. DIZAK. Yes.

Chairman LAFALCE. What is it that is precisely being said?

Mr. DIZAK. The average pretax income amongst franchise owners was $124,290, exclamation point. Ninety-four percent of franchise owners considered their franchise operations successful. Seventy-five percent of franchise owners indicated knowing what they know now, they would buy the exact same franchise if they had to do it all over again.

Chairman LAFALCE. I am only going to ask, we have gone round and round on the issue of success or failure, there is a question of who is included, who is not.

Mr. Brown says people like Subways are not, other franchisees are not called franchisees and are not included, others are terminated and bought by the franchisor and they are not counted. But I would like you to give me some indication of how we came up with this $124,000——

Mrs. MEYERS. I didn't hear you read $124,000.

Mr. DIZAK. The average pretax—this is from the flyer going out from the national franchise show.

Mrs. MEYERS. The average pretax——

Mr. DIZAK. The average pretax income among franchise owners was $124,290.

Mrs. MEYERS. I wonder what pretax income means.

Mr. BROWN. Before you pay taxes.

Mr. DIZAK. Gross income before you pay your corporate taxes.

Chairman LAFALCE. Could this be revenues?

Mr. DIZAK. It says income. It says income. Income is income. After you pay your expenses, after you pay everything, except Uncle Sam and the State taxes, your gross income is $124,290. I offered to change places with Bob here when I read that.

Mr. THURM. Mr. Chairman, Mrs. Meyers is correct. This is a gross income figure. Without objection, we will submit for the record the Executive Summary of the Gallup study.

Chairman LAFALCE. This is gross income before taxes, but is that what you are saying the average is? What do you say, Mr. Dizak?

Mr. DIZAK. Pretax income is self-explanatory. Pretax refers to after your expenses have been paid. If it is gross income, say gross income. It doesn't say gross income.

Chairman LAFALCE. Did you say it said gross income, Mr. Thurm?

Mr. DIZAK. Big difference.

Mr. THURM. The Gallup organization study refers to estimated gross income before taxes. I am not familiar with the brochure Mr. Dizak is referring to. Also——

Mr. DIZAK. It is on the back page.

Mr. BROWN. Would you offer a retraction before the show opens tomorrow——

Chairman LAFALCE. What do the television ads refer to?

Mr. DIZAK. The exact same thing. That exact same figure was used on television, and the same terminology.

Chairman LAFALCE. Do the ads indicate the amount of investment that might be necessary to make this average $124,000?

Mr. DIZAK. No, it didn't, but if you notice at the close of the TV commercial, the background will show Pizza Hut, McDonald's logos.

Chairman LAFALCE. Do they use those words in the TV ad, as low as $10,000?

Mr. DIZAK. Yes, they did.

Chairman LAFALCE. No further questions.

Mrs. Meyers?

Mr. GARNER. Mr. Chairman, may I just drop a footnote on these statistics? One of them is cited, 75 percent of franchise owners indicated that knowing what they know now, they would buy the exact same franchise if they had to do it all over again. Let's assume that is true. That means 25 percent of the franchise owners would not do it over again.

Now, the important thing about this is, this is not a job where you go and work for an employer and if you are unhappy and want to do it over again, you can go get another job. These are people who have made an investment, usually a large investment, in the franchise and they don't have the choice to go change jobs or to go do it over again.

I think even on the face of the Gallup poll and taking it at its word, the 25 percent of the people saying they wouldn't do it over again is an incredibly high number. That, on the face of it, refutes the 94 percent number.

Chairman LAFALCE. That is taking it on its face. Mrs. Meyers.

Mrs. MEYERS. Contract law is usually in the area of State law, is it not? Would this be the first time, under this law, that the Federal Government has been interceding in this area of State law?

In other words, it would give a Federal right of action, would it not, in contract law which has previously been State law? Am I saying that correctly?

Mr. GARNER. I don't think we need to look any further than the Petroleum Marketing Practices Act for at least one answer to that question, and also the Automobile Dealers Day in Court Act. Both of these are Federal statutes.

The PMPA in particular overrides not only private statutory law in the States on the relationship between a refiner and a gasoline station franchisee covering termination, nonrenewal. It preempts State law in that area. The same is true for the Automobile Dealers Day in Court Act.

Now, I am sure that there are many other examples. The securities laws, for example, extensively, pervasively regulate the sale of securities, which prior to that time was simply a matter of buy and sell, a matter of contract.

Mrs. MEYERS. They regulate, but do they give the right of suit of a private action?

Mr. GARNER. Yes, they do.

Mr. BROWN. There is an interesting sideline to what you have just said. I agree with everything that Mike has said. But the sideline is this. The Federal courts themselves are seriously overburdened.

If a private cause of action is to be granted here, may I suggest that the committee give some consideration to what we call dual or concurrent jurisdiction. For example, RICO may now be sued upon in State courts. I think the very latest implication of the Supreme Court of the United States is that PMPA, the Petroleum Marketing Practices Act, may also have litigation in State courts in order to avoid the question that is implied in your statement, and that is, are we going to burden the Federal courts with another million cases or something like that.

Mrs. MEYERS. Well, that was part of it, Mr. Brown, but also I am not an attorney, as you may be able to tell, but I was in my State Senate, and I know that in a lot of cases States have wanted to keep control of some of these laws. They would like to state how far a private right of action can go in some of these contract laws. They don't want to be preempted by the Federal Government.

Mr. BROWN. There is an answer to that, too. There are 18 States that have in fact adopted broad legislation for franchisees generically. But the effort of franchisors has been to say, You have got to do it in each industry.

Now, if you take each industry, automobiles have statutes in all 50 States. Gasoline franchisees did but PMPA preempted that and knocked it out. There are hundreds of bills that protect, say, buyers of a particular product like farm equipment or things of that sort, liquor or whatever, and those are all over the United States. A whole crazy quilt.

I think what we are suggesting here is, isn't it time to make it uniform—it doesn't matter what State you happen to live it, shouldn't you have a break?

Mrs. MEYERS. I really appreciate your comments, and I do want to protect the rights of people very much.

I am greatly concerned about litigation, and you commented about the one franchisee who had sued and had received $9 million, and I presume most of that was in punitive damages.

Mr. BROWN. All punitive damages.

Mrs. MEYERS. So then you commented how many more cases had been brought against that person. I wonder how many of those were because they had been dealt with badly and how many of them were because people saw $9 million glittering in big letters?

I really do think that we have got to try to encourage people to resolve their concerns in better ways than going to court.

I think most businesses really—and I think you would probably agree with this—most businesses really want to do right with the people who they deal with. Most businesses really, I think, fear punitive damages the most.

Mr. BROWN. That doesn't stop this particular company who for 15 years continued to do it up to 3 months ago. They are still doing it. The important thing is that in spite of these big damage awards, the company is still doing it.

Mrs. MEYERS. The Iowa law was passed in 1992. The agreement between—or the idea to set up a dispute mechanism was last February.

I would like to see what happens in Iowa, if indeed it prevents franchisors from entering the State, because I think that has been the comment. I don't know whether it will or not.

Mr. BROWN. It never will. In the 18 States where they have it, they have gone in just as heavily. The States are California, New York, Texas, Illinois. You know perfectly well that franchisors have gone in there repeatedly and constantly and they have these regulations. It is a false defense.

Mrs. MEYERS. In the Midwest we are a lot—well, I won't say that.

Mr. THURM. Let me say on that point that Mr. Brown was correct that we did meet formally last week or a week and a half ago for the first time, although we were in a meeting together before that. But even before we met, I had heard about the wonderful, marvelous anecdotes told by Harold Brown, and I am glad and honored to be added to Mr. Brown's list of anecdotes.

My recollection of our discussion is substantially different than his recollection. Maybe that is why all of his stories are called anecdotes.

On the issue of litigation, I must say that I think this discussion is extremely helpful and is a very major point toward why we are pushing this mediation process. Litigation is not a good solution.

Let me read this to you, Mr. Chairman, very briefly. "Litigation is expensive, time consuming, abrasive and long lasting. Parties should exhaust every conceivable form of dispute resolution before getting caught in that kind of imbroglio. Reputable attorneys know that, subscribe to it and usually do their utmost to advise their clients accordingly. For those counsel who are not so impelled, their problems lie elsewhere, possibly in their moral or educational deficiencies, in life's distress or simply in the current worship of the dollar."

I quote from my friend Harold Brown, New York Law Journal, December 26, 1990.

Mr. BROWN. One-hundred-percent correct.

Chairman LAFALCE. Let's move on a bit. I just want to make the following observations. What percentage of franchisors deal inter-

state as opposed to intrastate, would you say; 96 or 94 percent, or higher?

Mr. BROWN. A very large percent. Maybe regionally, maybe not totally over the whole Nation.

Chairman LAFALCE. I am not saying all 50 States, but interstate. So we are dealing with franchisors who deal interstate.

What tendency is there for franchisors to put a provision in the contract that says, the law of this particular State shall apply to all arbitration, all litigation, et cetera? For example, the law of Montana.

Anybody want to comment on that?

Mr. BROWN. Sure.

Chairman LAFALCE. Mr. Brown?

Mr. BROWN. The worst case is one against a Burger King in the Haagen-Dazs setup, where the franchise agreement selected New York State law to apply, because the franchisor's home office was there. The suit was brought in Minneapolis by 124 Haagen-Dazs franchisees.

In applying the rather abstruse question of choice of law, the district court judge held that New York law did prevail, and that the laws of all of the States in which the 124 franchisees were located were void and inapplicable because of that choice of New York law. He even forgot to say that they couldn't sue under New York law unless they were citizens of the State of New York or had a place of business in New York.

Now, Minnesota was so furious, the next day they passed a statute changing it, and the next day after that, the governor signed it. Unfortunately, that change was held not to be effective retroactively, but that is a perfect illustration.

Chairman LAFALCE. So even if you have a State law, if there is a provision in the contract, and there are in most contracts, that establish the law of a different State, the law of your State is irrelevant, isn't it?

Mr. BROWN. It is if you take the minority view. The majority position is beginning to come around to the view that have two district court judges who have said a beautiful thing. They said, "We refuse to be controlled by the stroke of a lawyer's pen," and that "ain't the law." The fundamental public policy of the local law will apply if it is clearly stated.

But just 30 days ago in Detroit, Michigan, a district court judge said that their wonderful conduct statute did not either represent "fundamental law" or "local public policy," and therefore he applied the law of Georgia, where there was no protection whatsoever. That was 30 days ago. So there isn't uniformity yet.

Mr. GARNER. Let me make a comment on the issue of choice of law and inclusion of a choice of law in a franchise agreement. This is an area where the courts do not agree, do not follow consistent rules.

Chairman LAFALCE. They need a little Federal guidance.

Mr. GARNER. I agree, they need a little Federal guidance. Whether you have a choice of law provision in the franchise agreement does not necessarily dictate that you are going to have that State's law apply. So in approaching the dispute, there is a tremendous amount of uncertainty.

That uncertainty translates into motions before the court, which means that there is a huge amount of legal expense, judicial expense, uncertainty expended on what I characterize as deciding what shape the table is going to be.

Chairman LaFalce. You think the more certainty, the less litigation?

Mr. Garner. That is correct.

Chairman LaFalce. I agree.

Mr. Mfume?

Mr. Mfume. Thank you very much, Mr. Chairman.

Let me say for the record I have seen the commercial that was mentioned. With all due respect to Mr. Dizak who attempted to replicate the announcers, the commercial is far more enticing through use of music and graphics, and it does lead one to believe this is a great area which you cannot fail in if you are just prepared to step forward.

Having said that, let me say I was particularly interested and thought I would hear this morning from Mr. Thurm following previous hearings some discussion about the historical practices that have adversely affected the minority business community as a subgroup of individuals in the area of franchising. I am talking specifically about Latinos, African Americans, and Asians.

We have heard reports of redlining by franchisors who steer minority individuals into low-income areas, who engage in the practice of price discrimination with regard to leasing and purchasing of stores and equipment, and then acts of all sorts of retaliation against those individuals who happen to complain about such discriminatory practices.

I am really interested about knowing to what extent steps have been taken to adequately address those concerns. So I regret not hearing that in your remarks.

However, let me go back to this code of ethics, which I find kind of interesting, and I certainly would want to see it, as I am sure would other members of this committee.

Mr. Thurm, does it speak, sir, specifically to the matter of redlining?

Mr. Thurm. Redlining I don't believe is specifically itemized in the code of ethics, and we can go through that with you, Congressman.

In terms of our overall program, though, I am sorry that it wasn't in my statement, but I will also be glad to bring to you a lot of information that our association is doing now in the whole area of minority business development.

Mr. Mfume. Would you tell the committee why it was not a part of the code of ethics, as some of us seem to think it is a very important issue?

Mr. Thurm. I am not sure it isn't a part of the code of ethics, although it is not specifically listed as such. I believe it is covered. We will provide you with more information for the record.

Mr. Mfume. I assume it either is or it isn't.

Does the code of ethics speak specifically to the matter of price discrimination?

Mr. Thurm. I will, again, be glad to get back to you with all the details about all the provisions in the code. I do not have with me

all the details that deal with the specifics, but we will provide that for the record.

Mr. MFUME. One final question about the code. Does the code prohibit acts of retaliation against franchisees?

Mr. THURM. My recollection is that would be generally covered in the code.

Mr. MFUME. Mr. Brown, on page 10——

Mr. BROWN. Pardon me, may I just respond to your last question?

Mr. MFUME. Yes, quickly, because I have a limited amount of time.

Mr. BROWN. The State of Washington bill specifically addresses the issues that you have described. Perhaps I should have told you about our case against Burger King in which I represent 24 Blacks, Asians, and Hispanics who are suing precisely on the matters that you describe, and I know of others, for example, Wendy's where one man has—a Black man—has 26 franchises and he can't take his family out to dinner. He doesn't make enough money.

Where the discrimination is terrible and where our efforts in the litigation area have not been going greatly—Judge Kehoe in Miami just came down with a ruling that is a killer. Burger King, one of the big supporters of this, please listen carefully to what Burger King has done.

Mr. MFUME. This meaning the code of ethics?

Mr. BROWN. That is right. Burger King has just settled with 12 of those franchisees, Black, Asian, Hispanics, and has required each of them to sign a document in which they state, "We made false statements when we brought the lawsuit, and we hereby retract them."

When their lawyers said, "Good God, you can't sign that," they said, "that is the only way we can get the settlement," so they signed it. Mr. Burger King, what is your response to the horror in that settlement agreement? Signed just 60 days ago.

Mr. MFUME. On page 10 of your testimony, you said, and I am quoting now, "The Achilles heel of the IFA's ethical code is the lack of any meaningful system in formulating its terms and its administration in its enforcement?"

Mr. BROWN. That is correct.

Mr. MFUME. "There are no established procedures for fair, speedy, inexpensive and impartial justice, and the overwhelming power of individual franchisors will not only continue, but will grow in its ability to stifle complaint."

That is either a very powerful observation or an indirect indictment of this ethical code in the IFA. I am going to ask you in just a moment to respond to that as a result of my comments regarding this code of ethics.

Mr. Garner, I would like to take you back, if I could, to page 9 of your testimony where you say that perhaps the greatest difficulty the franchisees face is the high cost of litigation. Yet as I understand with this code and this aspect of dispute resolution, it is a matter of going through a process and then going through a legal process if that fails.

But you also said on page 9 and picking up on page 10 that one of the great ironies of the present scheme of regulation is that

franchisees who receive erroneous information through the disclosure process have no right, as the Chairman pointed out in his remarks, under FTC rules, unless they can find some other way to prove themselves, and that this burden of proof then becomes overwhelming.

I am going to ask both of you, and I don't have much time left, if you could briefly respond to those two aspects of your response. Specifically, Mr. Brown, to you as it relates to this code of ethics, which we are still waiting to see.

Mrs. MEYERS. Mr. Chairman, can I follow with a question?

Mr. Brown——

Chairman LAFALCE. Is this in connection with Mr. Mfume's question?

Mrs. MEYERS. Yes, just a follow-up.

You said that these individuals signed papers stating they had submitted false information, that they had lied in order to get a settlement. This may have been something that was a terrible pressure on the individuals. Had any of them, to your information, actually submitted false information?

Mr. BROWN. None whatsoever. Their law firm is in Baltimore. The lawyers representing them will repeat to you exactly what they repeated to me. They said they had never in their lives ever seen such a requirement in a settlement. It was false. There was no choice. They begged their clients not to sign it, but they did.

Mrs. MEYERS. I am trying not to take one side or the other, but I do know that sometimes people who are being sued feel it is in their best interests to settle, that it is more expensive to go on through extensive litigation, and so they settle. But sometimes they also like to establish the fact that, although they are settling, they were pressured into it also. So there is pressure on both sides of this litigation.

Mr. BROWN. Perhaps—just in answering your question.

Mr. MFUME. Please.

Mr. BROWN. To give one sentence describing that litigation, what I am telling you is fact. I have verified it and we have evidence.

The minorities that I have been describing—and I won't repeat it—were consistently over a period of 10 or 15 years confined to what I can only call a ghetto, places where franchises had fallen apart, were no longer viable, the building was there but there just weren't the customers.

When the Black people—I will say Black but I mean all of them—were induced to buy those at high prices, by the way, they then said to Burger King, well, let us get a few franchises in the white communities where there are viable franchises, and the answer was no. Therefore, they were kept out of viable areas, and only allowed to function in these places where nobody could succeed.

Now, that is the critical issue of this case. There were 24 plaintiffs. There are many other Burger King franchisees that know that as a fact. They are currently franchisees and therefore their lips are sealed. They don't dare talk because they will suffer from that talking.

So the facts that were involved in that litigation are immutably correct.

Mrs. MEYERS. I can't argue with you, obviously. But that sounds unusual to me.

Mr. THURM. Congresswoman, I would say on a lot of these cases we have heard about today, if the panel is interested, there should be an opportunity to hear the other side as well, and I think there are other sides to the stories we heard today.

Congressman Mfume, when you see the code, there is a specific reference to discrimination. It basically says a franchisor shall not discriminate in the operations of its system on the basis of race, color, religion, nationality original, age, disability, sex——

Mr. MFUME. But how is it enforced?

Mr. THURM. The question of enforcement is a very important question to us. That is one of the items I mentioned earlier. We have asked our Franchisee Advisory Council to help us with that.

Mr. MFUME. Can I expect that I will get damages punitive or trebled if I am aggrieved and proven to be correct in my assertions? If I am a franchisee, can I expect that will be part of the final report?

Mr. THURM. I don't know what will be in the final report. I do know that the enforcement is a whole part of this process.

Chairman LAFALCE. We do not have a provision within our legislation for punitive damages. We do not have a provision for double or treble damages, but we do have enforcement.

Is there any enforcement mechanism contemplated for franchisors other than something that they would voluntarily agree to, or if they wouldn't voluntarily agree to it, anything other than expulsion from your organization?

Mr. THURM. Expulsion and being ostracized may be as harsh a remedy as there is.

Chairman LAFALCE. I think that is very important. In other words, under your self-regulation scheme, it would have to be something that the franchisor, number one, voluntarily agrees to some settlement, or if the franchisor doesn't voluntarily agree, the ultimate, the most severe punishment would be expulsion from your organization. Is that correct?

Mr. THURM. Well, it may or may not be, Congressman, because there is a lot of value, in my opinion, to belonging to a reputable trade association.

Chairman LAFALCE. I don't dispute the value of belonging to the IFA. It is simply a question of whether or not the ultimate sanction might be expulsion from it. If 75 percent don't belong, some people might not think that is the worst thing in the world that could happen to them.

Mr. THURM. It is possible a greater punishment would be embarrassment amongst his colleagues related to being ostracized. There are a variety of things that take place in these codes.

Chairman LAFALCE. Would that satisfy you, Mr. Mfume, they would embarrass the franchisors?

Mr. MFUME. Not hardly, Mr. Chairman. Not hardly at all.

Mr. THURM. I would say, Mr. Chairman, this is not the first code of ethics that has been created. It is also not the first time a trade association has looked toward self-regulation. In fact, there are some textbooks on the subject that say that is a major part of what trade associations do.

Chairman LaFalce. You are taking a step in the right direction. I applaud the effort. The question is the adequacy of it, as perfect as you might be able to bring self-regulation.

I regret that I have to personally absent myself for about 20 minutes, but I do have many more questions and, therefore, I expect the hearing to continue until I come back, and I have asked Mr. Mfume if he could chair the hearing.

Mrs. Meyers. Mr. Chairman, I regret also that I have to leave, and perhaps it is a good thing, I am feeling a little outgunned here, but——

Chairman LaFalce. I am sorry, we did have three of your Members here in attendance. I am sorry they left.

Mrs. Meyers. The hearing went a great deal longer than I think people thought it would.

I do think that the—I am glad that you made the remarks that you have just made. I do think that we are taking a step in the right direction, if they are moving toward a code of ethics and an attempt to set up a dispute resolution mechanism with franchisees, an attempt to be more inclusive. I don't know that you can expect a trade association to be a punitive organization.

Chairman LaFalce. You can't.

Mrs. Meyers. I don't know that any others are, really. But at least you can set up the mechanism, you can ask people to try to adhere to this code, and it is a statement of your individual and personal beliefs as an association. I would think that was a very positive step in the right direction.

I, too, will try to get back, but I had no idea the hearing would go this long. So I am sorry that I have to leave.

Chairman LaFalce. Mr. Mfume, can you take over for a while? Thank you.

Mr. Garner. Mr. Mfume, I would like a chance to respond to the question you asked me. I referred to three items in my testimony and I would like to put them in context, the first being the absence of a private remedy for violation of the FTC rule.

The result of that is that if a franchisee contends that it has been defrauded by representations that the franchisor has made, it must proceed to prove in essence a common law fraud claim. A common law fraud claim requires that the franchisee prove, among other things, that the representation was false when it was made, and that the franchisor knew it was false, and intended to defraud the franchisee.

Now, that can be done, but usually not without access to the franchisor's internal records and documentation. That is where that type of proof comes from in a typical lawsuit.

That type of information is something that in Federal and State litigation you can obtain through the discovery process. That is a very expensive, intensive process.

The concern I have about self-regulation is that process is not available. I don't know what exactly the proposals that IFA is making contemplate, but I am very concerned that what we would find under the current proposal is the franchisee does not have a remedy under the FTC rule, the franchisee goes into a dispute resolution scenario without the tools that it would need in court to prove a common law fraud case.

So it is kind of like playing the game with half a deck. That, in turn, leads to another concern, which is whether the alternative dispute resolution mechanism is simply spinning wheels as far as the franchisee is concerned.

Mr. MFUME. [presiding.] Thank you.

Mr. Poshard?

Mr. POSHARD. Mr. Chairman, may I ask unanimous consent to submit a statement for the record? I have three subcommittees going on right now and have to leave. Thank you.

[Mr. Poshard's statement may be found in the appendix.]

Mr. MFUME. Mrs. Clayton?

Mrs. CLAYTON. I want to thank the panel for their representation and giving some of the graphic interplay between the two parties and some of the difficulties.

I want to say that self-regulation by a trade organization is not unusual and is the normal procedure. It is for doctors, lawyers try to do that, accountants trying to do that. So that is the procedure normally in trade associations or professional groups.

However, there is the kind of delicate relationship and balanced relationship between the position of the franchisee in relationship to those he is contracting with. It is not a normal contract. You really don't have equal partners in here.

I just would like to hear from I guess, Mr. Thurm, what your feeling is, what else needs to be done. I don't say that you shouldn't have self-regulation. I just think that is—I am surprised you didn't have it before, reading the articles in The New York Times and the industries where it is indicating you are doing it now because you know there is going to be regulation.

But I am suggesting you should indeed have those, and those are the standard norm. But what else would really bring that into balance from your standpoint?

Mr. THURM. I think we need to give this process a chance to get off the ground. It is a very new process. You were right in saying that self-regulation is very common among the Nation's thousands of trade associations. It is new for us. Perhaps it is new because a lot of these concerns that we have been hearing about have been reported recently. Although, again, realize there are other sides of the stories you have heard today.

In terms of the contract process, I am not sure that a contract between a tenant and a landlord is any more balanced. I am not sure a contract between an employee and his employer is any more balanced. That is the nature of contracts. You have a voluntary agreement between the two parties. Hopefully, the parties will understand that agreement and will have read it fully ahead of time and had the advice of counsel.

Mrs. CLAYTON. I don't have much time. I am surprised you are just hearing about it when in fact by your own testimony you said $758 billion, some 7 million people. That is a lot of activity, to suggest that these are new. It is an enormous amount of economy. Seven million persons involved in that, the volume and the opportunity for the evidence should have been there.

Let me just go to Mr. Brown and Mr. Garner, both who are attorneys. What do you suggest would be those things that would equalize the playing field between franchisee and franchisors?

Mr. BROWN. For years I have suggested that litigation is a ridiculous procedure that saps the strength of both sides, makes lawyers rich, and doesn't really provide the kind of productive and constructive method of marketing that we would prefer.

Now, the alternative offered by franchisors has been one-on-one, "my door is always open, you can come in and sit with me and my eight advisers and we will deal with you," and you know what that person gets? Nothing.

The only suggestion that I can think of as the alternative is the one you have indeed proposed in the statute, and that is affirming not only the First Amendment's freedom of association for all franchisees to join their independent group, but also a regulation that would preclude franchisors from refusing to deal with franchisees as a group. That will bring not only the economic and psychological factors into posture, but also bring other things that a franchisor is going to recognize. Maybe you can get rid of some of these lawyers and court burdens and things of that sort.

I suggested and the Chairman mentioned that your legislation in so proposing—and by the way, it was also proposed in the State of New York, in Mr. Bianchi's legislation, will stand as a landmark for a franchisees' bill of rights.

The phrase that I quoted that the Chairman referred to was that "the success of their franchisees will redound to the benefit of franchisors," and it may take them kicking and screeching to heights of prosperity that they never anticipated.

The concluding aspect of what you are doing here, however, is in my last sentence in my statement. As Judge Louis Brandeis suggested in his book, "Sunshine has a wonderful, wonderful effect."

This open discussion of the problems therefore serves a marvelous benefit.

Mrs. CLAYTON. One final question. Should we be concerned about the relationship of different types of industry?

I have—and time doesn't permit—complaints from citizens who have had problems in the automobile dealership. I have also referenced in The Wall Street Journal about the one Mr. Brown talked about, Subway.

Are there different relationships about the nature of the industry between the franchisor and franchisee?

Mr. DIZAK. I would like to answer that. On the point that it is somewhat similar to a relationship between a landlord and tenant, I take strong disagreement, because a franchisor and franchisee are supposed to have a working relationship, a partnership to a common goal.

I want to make another comment, even if the IFA's regulations would work, assuming that they could work, if it is only covering 25 percent of franchisors, who is going to protect the other—who is going to enforce the other 75 percent?

The other factor is that I mentioned as far as even attorneys here mentioning the franchisees they represent are larger franchisees that can afford their fees. What I am saying is that most franchisees cannot afford lawyers' fees. They are sunk, and this is what this legislation should take care of.

If it is in the disclosure documentation, it would stop the abuses, and therefore the smaller franchisees would not have to fold their tents and just eat their losses because they can't afford attorneys.

Mr. MFUME. Would you go to the heart of Ms. Clayton's question, though, with respect to different types of associations, relationships, I think she specifically was asking about that.

Mr. DIZAK. Yes, and again, addressing back to the factor, you can't compare somebody going into an automobile dealership, unhappy with the car, the service, whatever, he is a customer. There are always going to be conflicts like that. He is a customer, not a partner. A franchisee is supposedly a partner. That is what the difference is.

Mr. GARNER. I am not prepared to address the question extensively, but yes, there are differences in the types of relationships between franchisors and franchisees. I will tick off just a few of them.

Number one, you have some franchises where the franchisee makes a total investment of less than a few thousand dollars. It may be a part-time occupation for the franchisee. On the other hand, you have franchises where the franchisee makes a total investment in the millions of dollars.

Interestingly, at that end of the scale, there is probably less need for Federal intervention, because you are dealing with very, very sophisticated franchisees. Then you have everything in between.

Sometimes the investment that the franchisee makes is what I will call a fungible investment, say the franchisee leases space, even under a month-to-month tenancy. So if the business fails, the losses are not as great as in the other case where the franchisee makes what we will call a sunk investment. That means an investment in a building, in equipment, in real estate that is dedicated to that particular franchisor's use.

In that kind of a situation, if the business fails, that investment cannot effectively be turned to another productive use, because it is dedicated, the architecture is the franchisor's architecture, the equipment is especially designed for that franchisor.

You have differences in systems where the franchisor owns the land and possibly the building, and rents it to the franchisee, or perhaps the franchisee rents the land from a third party and owns the building.

I have ticked off some examples of these. They are differences. They can make a difference in the consequences to the franchisee of nondisclosure, of abuse in the relationship. I do think that it is something that the committee should consider. I regret that I am not prepared to expand on it more at this time.

Mrs. CLAYTON. Just a yes or no answer. You think the legislation as proposed, the disclosure would address those differences?

Mr. GARNER. I think on the disclosure item, yes.

Mr. MFUME. Thank you, Mrs. Clayton.

Given the fact that we are not certain when the Chairman may return, some Members do have other competing hearings.

Mrs. Roybal-Allard has been kind enough to be here all morning long, and I would like to yield to her for her own round of questioning.

Ms. ROYBAL-ALLARD. Mr. Thurm, the code of ethics that you are working on and the standards that you are developing, do they apply only to those who are members of your organization, or will that apply to everyone?

Mr. THURM. The code of ethics would apply to members of the International Franchise Association.

It is important to point out that notwithstanding some of the figures we heard this morning about a 25 percent figure, the more relevant figure is the fact that the International Franchise Association represents a vastly greater percentage of the franchised outlets in the franchise industry, and of the sales in franchising. These are the relevant numbers.

The number of franchisees and franchised outlets is vastly greater than the few upstart numbers that might have been referred to.

We would also like to see the day when all of those franchisors become members of the International Franchise Association so that they will agree to abide by a code of ethics, that they will agree to abide by self-regulatory methods such as agreeing to sit down and mediate—all parties agreeing to mediate—and that perhaps would be the best result of all of this.

Ms. ROYBAL-ALLARD. But given the fact that not everyone does belong, nor is anyone really required to belong, the result is that, there are a considerable number of franchisors who don't belong and therefore there is nothing that requires them to meet even whatever minimum standards you have in your code of ethics now.

What would then be your recommendation to protect franchisees who do not belong to your organization and would fall under your guidelines if not some kind of minimum standards that would be developed by the Federal Government?

Mr. THURM. It is an excellent question. The International Franchise Association, in addition to all of these activities it is undertaking on behalf of its own membership, has long supported full, fair and tough enforcement of existing law by the Federal Trade Commission.

There are existing Federal and State laws that can and do protect franchisees. We are in favor of more enforcement power for the Federal Trade Commission.

Ms. ROYBAL-ALLARD. What we are hearing is that it isn't working, and we have seen case after case after case. Something has to be done. Given that whatever it is you are doing does not cover everyone, and let's say that whatever standards are put together at the Federal level, meet your code of ethics, and actually give some enforcement to your code of ethics, what would then be your objection, if in fact the codes were parallel to what you house with enforcement? Why would you object to that?

Mr. THURM. I think we will have an enforcement method, as I say.

Ms. ROYBAL-ALLARD. That is only for your members. I am talking about protecting those who are not part of your membership, and all the abuses that we have heard are taking place, some of which have been mentioned by Chairman Mfume. There are people who need to be protected who do not fall under your group.

Assuming you are able to develop a code of ethics for people who fall under your jurisdiction, we are trying to look at all those who do not.

My question is, why would you object to having some kind of minimum standards put in place that would protect the other franchisees, especially if those standards were not in conflict with what you are already proposing?

Mr. THURM. My point is that we believe a lot of those standards are already in place for the industry. Although there are reported cases where it is not working, and there may in fact be some cases where it is not working, I don't believe it has been documented that the system is broken. I think the system is working, and I think the success rates will bear that out.

If there are some weaknesses in the existing rules and existing laws, it may be in the area of the ability of the Federal Trade Commission to enforce the laws that it already has, and we would support more enforcement power for the Federal Trade Commission in this entire area.

Ms. ROYBAL-ALLARD. I guess what concerns me is when you have cases where there have been awards, the courts have found in fact there have been violations, that you are still saying, well, if they exist, or, in the event that they do—the fact is that they do exist, and that is what we are trying to get at.

Mr. THURM. Correct, and in those cases the system worked, because there were damages.

Ms. ROYBAL-ALLARD. But not always.

Mr. THURM. We would like to work with you to make it better.

Ms. ROYBAL-ALLARD. One more question. If I understood the testimony, there seems to be more of a problem with the smaller franchisors than the larger ones. I see one saying yes and one saying no.

Mr. BROWN. I am saying no.

Ms. ROYBAL-ALLARD. My question was, if in fact that is true, then what is it about the larger franchisors, that enables them to be better than the smaller ones?

Mr. BROWN. Nothing.

Ms. ROYBAL-ALLARD. I have a yes and a no here.

Mr. BROWN. Maybe we have given a wrong reference here. McDonald's is regarded, properly so, as one of the top franchise organizations. Does it have problems? You better bet it has. It has a 20-year franchise at the end of which, what happens? Buildings die.

The biggest problem facing McDonald's right now, as far as we are concerned, is they are sloughing off buildings that aren't worth it, that aren't worth the investment by a franchisee.

A Mr. Fisher, now in Ohio, was in Massachusetts, 3 years before the 20-year term was over. He was induced to come in and become related to McDonalds in that particular franchise, with an old-fashioned building, I will say, no drive-ins and otherwise old fashioned. The express statements were, "We will try to get a new building, and if we can't do that, we will help you with the drive-throughs."

So we signed up. When he went to the local people in Burlington, Massachusetts, they said, "We rejected that three times for the prior owner, and McDonald's was a party to the proceedings. Didn't

they tell you? He said, No. Well, there is nothing changed and we are not going to help you." So he lost everything.

Please don't think that because we haven't had a chance to recite all of the cases, that there aren't many other cases. There are many other cases, including automobile dealers.

I will tell you they have a bill pending before Congressman Brooks right now. They know about the Soler case. They are infuriated about it. They are trying to get the Federal Arbitration Act amended to make sure that there won't be any more Mr. Solers having to go to Japan and arbitrate in Japanese, the worst miscarriage of justice that we ever heard in this business.

A franchisee in the automobile industry may have a plant worth anywhere from $2 to $10 million investment in physical facilities. If he loses that dealership, for any reason whatsoever, he can't even blow it up. It costs almost as much to take it down as it did to build it.

The National Automobile Dealers Association is handling its own affairs ably and it is not for me to suggest otherwise, but I am going to be in the Supreme Judicial Court of Massachusetts on May 6th representing an automobile dealer who has had a terrible time. I won't go into that any further.

The problems are pandemic. What the voluntary alternate dispute resolution suggests, and I support it, and by the way, the organization behind it is one of the most wonderful in the whole world, that organization is helpless if people coming into it don't have good laws, decent laws, decent access to facts, and decent ability to present their cases in order to try to mediate. That is the difficulty. Nothing that the IFA has proposed would change that.

That is the Achilles heel of their proposal, as well as for the alternate dispute resolution procedure, which in itself is a wonderful, wonderful procedure.

Mr. THURM. Congresswoman, let me just add very quickly, in further answer to the question, if somebody has broken a contract, there are laws in every State to cover that breach of contract situation. If someone has been lied to, there are laws in every State to handle that situation.

If litigation is hard to come by, or if there is difficulty in the litigation process, that is a separate issue. That is not part of this process. But that is another reason why we are pushing for this mediation program.

The mediation program that we are developing, the National Franchise Mediation Program, is available to nonIFA members as well as to IFA members, and that the organization that we are dealing with, a very, very reputable organization, has a marvelous track record. It has solved in excess of 85 percent of its dispute cases through the mediation process. This involved different industries, and it deals with both large and small companies.

So we think there is a real good system in terms of this mediation process to bring the parties together, make them sit down and talk about their concerns. The track record suggests that 85 percent of those disputes will be settled that way without the pain, the suffering and the cost of litigation. What we are suggesting is, let's give it a chance.

Mr. DIZAK. You asked my opinion as far as—we have a friendly difference of opinion between myself and Mr. Brown concerning abuses with larger franchises versus smaller franchises. I think Mr. Brown's experience is limited to larger franchises. The larger franchisees are the only ones that can afford his rates. That is where there is a real problem.

I feel most of the larger franchisors as a whole cannot take the chance to get negative press. There are always going to be some people unhappy. You can never please 100 percent of the people 100 percent of the time. But the larger franchisors for the most part are in it for the long haul.

There are a lot of smaller franchisors that are in it 4 or 5 years to get a quick buck and run. These are the franchisees of those particularly franchisors that I feel need the protection, and again, they cannot afford lawyers. This legislation would protect them, because it would put the fear in those franchisors.

Chairman LAFALCE. [presiding.] I want to clarify some points. I surely intend that my legislation would do that, should it ever pass. We have three different bills, as you know, and I think there are different degrees of probability for each of them, and there is a certain gestation period. I am just trying to be calm and unemotional, Mr. Brown.

Mr. BROWN. Sorry.

Chairman LAFALCE. Should the fair practice bill pass, I would want to ensure that the contractual rights that exist between Mr. Dizak and his franchisees would automatically be borne by anybody who should purchase the assets of Mr. Dizak. To the extent that my legislation is unclear on that, I would seek your support in clarifying that.

Second, I surely do not want to make a Federal Court an exclusive court of jurisdiction. I would want to have concurrent jurisdiction over the right of action in both courts.

In fact, it would be my personal preference if we use the State courts, if that were available prior to the Federal courts, but I wouldn't want to put that in legislation, either. That is a personal preference.

I don't know that you could fine-tune something like that. But if we don't adequately make it clear that this Federal cause of action could be brought in both State and Federal Court, I think we would need assistance in clarifying that.

Mr. Thurm, I applaud the fact that you have come here on behalf of the IFA. As I said 3 years ago, 2 years ago, indeed a year ago, it was my desire to work with the IFA to help define the problems that exist in their true perspective, and to come up with what I believe is necessary, reasonable legislation to deal with it.

Subsequently, at some point last year, I came to the conclusion I would not be able to deal with the IFA. I hope that was a temporary lapse and that I can deal with the IFA in the future.

I think your testimony here is some indication that might be possible. I think that the steps you have taken are steps in the right direction. But I am still a little bit concerned that you—you being the IFA—might only want to do that which it can do internally.

I think given the best intentions, the best motives, your capacity to act internally as a trade association is so limited that you must,

if you really are proceeding in good faith, recognize the necessity of regulation and legislation, for the best interests of franchising. Whether that should be at the State level or the Federal level, reasonable people can differ on that.

I happen to believe strongly that it is in the best interests of the franchisors—forget franchisees for a second—to have one body of law to be concerned about, so they can apply it uniformly. It could cut down their expenses; it could enhance their predictability tremendously.

It is still my hope that eventually we might be able to achieve a compromise in franchising as I was able to deal on the subject of mortgage servicing rights, where I introduced legislation that was fought adamantly by the bankers association until they saw I wanted to be very fair and reasonable. We worked together over a 2-year period on every dotted "i" and crossed "t," and then their only problem was that they would only support it if in fact it preempted State law.

Again, I say that if the IFA were to ever support Federal legislation, then I surely would entertain the prospects of it preempting conflicting State laws. But they would have to actively support the passage of Federal legislation for me to entertain and concur with Federal preemption.

I know this might upset Mr. Brown, but if we get to that point, Mr. Brown, I think that is a problem that you could wrestle with at that time.

Mr. BROWN. I think the Federal courts could handle it.

Chairman LAFALCE. Federal preemption of law, but not so far as jurisdiction to hear the cases. I am not just talking about the fair practices legislation, but also the disclosure legislation. If you have a Federal disclosure requirement, let that prevail over individual State disclosure requirements.

Mr. BROWN. You have one problem, then. The best enforcing group of people in the United States are in NASA, and they are doing a wonderful job, in the 13 States. They are entitled to a lot of credit for us being here.

Chairman LAFALCE. Oh, they really are. Of course one of the things we have viewed when we were drafting our disclosure was not simply the FTC disclosure rule, but also the model disclosure law the States have proposed. Of course we tried to pick and choose what we considered to be the best elements of that.

Having put it in that note, I don't know that I want to get into nitty-gritty difficulties I had with anybody's testimony. I don't know that it would serve a good purpose at this point in time. But this problem is not going to go away. The potential issues are not going to go away.

Franchising will become an increasing way of doing business within the United States, for good or for bad. It will be for both good and bad. What we want to do is emphasize the good and minimize the bad.

It seems to me we need a body of law, a code of conduct, and a body of data in order to accomplish that. Again, I want to work with all individuals, franchisees and franchisors, franchisor associations, franchisee associations, anybody who wants to work with me, Republican or Democrat. But it would be difficult if at the starting

point there was an attitude of obstinacy, or yes, we will do anything in order to avoid legislation. No, I want to work with those who have the thought in mind, clearly legislation is needed, it ought to be a reasonable, balanced legislation.

Anybody else have any statement?

With that, I thank you very much.

The hearing is adjourned.

[Whereupon, at 12:45 p.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

Statement of

REP. JOHN J. LaFALCE, CHAIRMAN

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

Hearing on

FRANCHISING: IS SELF-REGULATION SUFFICIENT?

April 21, 1993

Today's hearing continues the Small Business Committee's inquiry into key issues of business franchising. During the past three years the Committee has endeavored to bring before the Congress a variety of issues and problems involving both the sale of franchises to the public and the conduct of franchise business relationships. This effort has sought to emphasize the growing importance of franchising in our nation's economy and to highlight the benefits and the pitfalls of franchising as an avenue for small business ownership and as a method for promoting small business growth.

Since the Committee's last formal hearing on franchising last July, I have noticed a shift in the focus of public debate over franchising--from arguments of whether serious problems exist in franchise sales and relationships to discussion of appropriate methods for addressing any problems or abuses that may exist. I see this as an extremely important and promising development.

In May, 1991, I addressed the annual legal symposium of the International Franchise Association (IFA), where I outlined the

problems the Committee had found in more than a year of investigation into franchising and offered the resources of the Small Business Committee to assist the IFA's membership to initiate a broad discussion of franchising problems and appropriate remedies. I explained my own philosophy of regulation as one emphasizing "what the private sector should and can do voluntarily, it should do; but what the private sector cannot do, government should attempt to regulate for purposes of the public good." I also expressed my belief that it was imperative for the assembled franchisors "to begin to address the problems of franchising to assure that their reputations remain unblemished by the actions of others, and to assure that abuses in the industry do not lead to unnecessary or excessive regulation."

I meant these words when I said them two years ago, and I continue to believe them today. Unfortunately, the type of broad, constructive dialogue between franchisors, franchisees and public officials which I had hoped to encourage at that meeting did not ensue.

In recent months, however, we have seen important signs of change. The incoming Chairman of the IFA, and several former IFA chairmen, have made public statements calling on franchisors to move beyond the "we-vs-them" mentality that has come to dominate attitudes toward franchisees and to seek increased cooperation and partnership. Last fall, the IFA revised its Code of Ethics to attempt to respond to many of the grievances expressed by

franchisees. More recently, the IFA has proposed a number of new initiatives to facilitate alternative dispute-resolution mechanisms, franchisor-franchisee councils and, even, eventual full membership in the association for franchisees. Influential voices within and outside the IFA have also called for concrete and meaningful steps toward industry self-regulation.

I would like to believe that the activities of this Committee may have been responsible, at least in part, for some of these positive developments.

The purpose of today's hearing is to initiate public discussion of self-regulation in franchising. The Committee is interested in the details of such initiatives now being undertaken and the outlines of those contemplated for the future. What forms should self-regulation take? How broadly would it apply? And what enforcement mechanisms are contemplated? Of equal interest are questions relating to the broader issue of self-regulation. Is self-regulation possible in franchising? And is it, in itself, sufficient to address the problems and disputes that appear to have increased in franchising in recent years?

Testifying this morning will be a panel of very capable experts on franchising who will approach this issue and these questions from a variety of perspectives. I had hoped that today's panel would also have included the current Chairman of the International Franchise Association, Stephen Lynn, who could have

offered the valuable perspective of a large franchisor, and at least one of two former IFA Chairmen who were also invited to appear today. Unfortunately, I understand that the demands of business and the many activities associated with the IFA's international franchise exposition later this week have precluded their appearance here today.

However, this is an issue the Committee intends to pursue again in the future and we surely will provide additional opportunities to hear from these and other witnesses, and it is my understanding that they are also desirous of testifying.

Let me emphasize once again the importance of the changed tone of debate amongst franchisors and also of the initiatives that are being discussed today by franchisors. Whether these initiatives can bring greater balance and harmony to franchising, or whether additional private or public measures are necessary, are questions that merit broad public analysis. As I stated two years ago, I believe it is of vital importance that all parties in franchising join in meaningful discussion of ways to improve this vital business concept that is of such critical importance for small business development and for our nation's economy.

STATEMENT OF CONGRESSMAN GLENN POSHARD
COMMITTEE ON SMALL BUSINESS
APRIL 21, 1993

Mr. Chairman, thank you for arranging this hearing and providing our committee the continued opportunity to explore issues relating to franchising. I believe our previous hearings have helped define some of the issues facing an extremely large and important sector of our economy, and I know you have introduced a series of bills to address some of the concerns which have been raised in those sessions.

Franchise operations provide a unique opportunity for entrepreneurs to put their talents to work and achieve success. And they are often the source of the first paycheck for our young people who are saving for college or helping their families make ends meet. Because franchise operations are such a large part of our economy, I believe the Small Business Committee has a responsibility to examine how these arrangements work and whether improvements can be made which will benefit everyone involved.

Mr. Chairman, I appreciate having this opportunity and look forward to the testimony from our excellent panel of witnesses.

STATEMENT BY CONGRESSMAN JIM RAMSTAD OF MINNESOTA
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
HEARING ON "SELF-REGULATION" IN THE FRANCHISE INDUSTRY

April 21, 1993

Mr. Chairman, I would like to commend you for calling this hearing on the issue of self-regulation in the franchise industry as part of your ongoing investigation into franchising.

As you know, franchises are extremely important to the American economy. Nearly one-third of all goods and services in this country are sold through franchises. John Naisbitt, the author of Megatrends, estimates that this figure will rise to around 50 percent by the year 2000.

Franchises employ over 7 million people in this country -- and have been a consistent source of new jobs in our beleaguered economy.

That is why it is absolutely imperative that we avoid over-regulating these important small business entities.

Under current law, the Federal Trade Commission (FTC) and the Unified Franchising Operating Circular (UFOC) require detailed financial disclosure information. This information, combined with normal legal and contractual business safeguards, helps protect franchisees.

It is important that we not enact laws at the federal level similar to the recently-passed Iowa statute. That law appears so onerous that many major franchisors have said they will no longer establish franchises in that state.

Enacting such a law would deprive American consumers of the retail choices available through franchises and restrict the ability of America's small business men and women to own and operate franchises. That is a tragedy we all want to avoid.

Thank you again, Mr. Chairman, and I look forward to hearing from our witnesses today.

STATEMENT OF HAROLD BROWN

Hearing on

"FRANCHISING: IS SELF-REGULATION SUFFICIENT?"

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

April 21, 1993

There has been a recent surge in legislation and legislative proposals both at the state and federal levels. A relationship termination bill was introduced in the South Dakota legislature on Jan. 27, 1993, patterned on the all-inclusive 1992 Iowa statute passed in 1992.[1] In addition to the familiar "good cause" restrictions, So. Dak. House Bill No. 1256 would impose a mutual statutory duty of good faith; permit acquisition of equipment, supplies, and services from outside sources; prohibit denial of transfer without good cause; and bar encroachment within "an unreasonable proximity" of an established franchise. Similar public policy proposals have been offered in Texas (S. No.195) and Arkansas (S. No.227) for restaurant franchisees. The Texas measure is a relationship-termination law that also provides a private remedy for the franchisor's failure to comply with the FTC pre-sale disclosure rule. In addition to other restrictions, it would expressly bar encroachment "within such proximity as would cause an 8% or more reduction in gross sales in any month during the next 24 months." The Arkansas "procedural fairness" measure would prohibit contractual provisions purporting to apply extra-state laws to local businesses or a contractual choice of extra-state venue. It is expressly "declaratory of public policy" and "intended to apply to franchises granted, transferred, renewed, or in existence on or

---

[1] For the Iowa statute, see (CCH) Tr. Reg. Rep. ¶4150, et seq.

after the law's effective date." A Washington bill (H. No. 1698) would amend already strong franchise legislation to prohibit discrimination between franchisees on the basis of "race, creed, color, national origin, sex" or the presence of any broadly specified physical handicap.

Both McDonalds Corp. and Holiday Inns have constitutionally challenged the Iowa statutory declaration that the act shall apply to existing, as well as to future franchisees. By now, they must realize that the impairment of contract claim is not mechanically applied, that it depends on the public policy factors, possibly whether they are "fundamental," and that a clear expression of legislative intent will probably prevail.[2] Recent bills have included express language to that effect.

On the merits, it would be unwise for a legislature to adopt such a significant statute to protect thousands of future franchisees, but to restrict its application to present franchisees. The million or more franchisees in the nation have been responsible for the extraordinary growth of franchising and the wide-spread success of many franchise systems. There would be grave injustice in their exclusion from "good cause" protection until ten or twenty years later when their existing contract terms expire.

Further, these statutes regulate certain "bad faith conduct"

---

[2] See, e.g. Solman Distributors, Inc. v. Brown-Forman Corp., (CCH) Bus. Franch. Guide ¶9487 (1st Cir. 1989). (application to existing dealers is constitutional where policy is clearly stated).

rather than the franchise agreement. At common law, the "bad faith" standard arises either as an implied covenant,[3] a duty founded on the gross imbalance in the relationship,[4] on equitable principles, or as a per se violation of "little" FTC Acts,[5] all of which are amenable to state legislative authority. Several courts have questioned the very existence of a contract that reserves unlimited power to the franchisor, as almost all of them do, opting instead for the implied covenant of good faith and fair dealing to prevent the contract from being declared a nullity.[6] That good faith duty is strongest during performance and termination.[7]

Much of the current surge of state legislation and proposals has been guided and inspired by federal legislation offered by

---

[3] Wright-Moore Corp. v. RICOH Corp., 908 F.2d 122, (CCH) Bus. Franch. Guide ¶9665 (7th Cir. 1990), after remand, 794 F.Supp. 844 (N.D. Ind. 1991), aff'd, ___ F.2d ___ WL 322668 (7th Cir. 1992).

[4] Arnold v. National County Mutual Fire Ins. Co., 725 S.W.2d 165 (Tex. 1987); Manges v. Guerra, 673 S.W.2d 180 (Texas Sup. Ct.1984); Christensen v. Integrity Insurance Co., 709 S.W.2d 724 (Tex. App. (Houston 14th Dist. 1986); Dunfee v Baskin Robbins, Inc., 720 P.2d 1148 (Mont. Sup. Ct. 1986) (CCH) Bus. Franch. Guide ¶8606.

[5] Anthony's Pier Four, Inc. v. HBC Associates, 411 Mass. 451, 583 N.E.2d 806 (1991) (bad faith breach of contract, based on effort to obtain higher payment, constituted violation of "little" FTCA, requiring remand for consideration of statutory exemplary damages).

[6] Scheck v. Burger King Corp., 756 F.Supp. 543 (S.D. Fla. 1991); Scheck v. Burger King Corp. CCH Bus. Franch. Guide ¶10,049 (S.D. Fla. 1992).

[7] See, Market St. Assoc. Ltd. v. Frey et al, 941 F.2d 588 (7th Cir. 1991).

Congressman John J. LaFalce (D.N.Y.) that duplicates his control and disclosure measures pending in the last expired session, with some important modifications.[8] That program is so significant that it will require an entire article or more. It reflects a confirmed commitment by the Buffalo, New York Congressman and a solid bloc of non-partisan supporters in the entire House. It has indeed invoked both action and attack by the International Franchise Association against its provisions and the Congressman himself.

The disclosure proposal would authorize a private action to enforce the FTC PreSale Disclosure Rule as originally recommended by the FTC when the Rule was adopted in 1979. It is currently enforced in many states with a private right under "little" FTC Acts. The International Franchise Association fought the Rule's original adoption for a decade; since 1979 it has succeeded in hobbling the Rules enforcement by Congressional mandate. Demonstrably, the franchisor's flouting of a long established and beneficial rule merits immediate adoption of private recourse for violations. Comparable private recourse also exists in the eighteen states requiring pre-sale registration or disclosure; some of those states overlap "little" FTC Acts that provide the same relief for violations of the FTC Pre-Sale Disclosure Rule.

The conduct proposal duplicates important protection that has prevailed for as much as twenty years in almost all of the major commercial states without demonstrable injury to franchisors or

---

[8] House Bills (103rd Congress, 1st Session) HR 1315, HR 1316 & HR 1317 introduced in Congress on March 11, 1993. (CCH Bus. Franch. Guide Report No. 159, March 24, 1993.)

franchising, but with substantial relief for franchisees and consequent consumer benefits. Among other important provisions, it relies on the broad definition of good faith that prohibits the denial of the fruit of the contract to the franchisee and mandates action reasonably anticipated and needed to achieve that purpose.[9] In addition to protecting the franchisee freedom of association, it prohibits a franchisor from preventing franchisees from attempting to resolve disputes with their franchisor through collective action. It also requires franchisors to perform competently under industry standards. It prohibits the use of numerous procedural and contractual devices to restrict franchisees' right to local relief in court or arbitration. This statute would only apply prospectively.

The third bill is an information filing and reporting measure covering a wide range of specific data. These materials would be government analyzed and published. The purpose would be to develop reliable data on information for prospective franchisees and the public, especially federal and state regulatory authorities. The need for such statistical analysis is evident from a serious dispute over termination and failure rates in franchising and as compared with non-franchised businesses.[10]

The International Franchise Association's broad scale attack

---

[9] See attached Appendix A entitled "Comments on the Scope and Application of the Doctrine of Good Faith and Fair Dealing in Franchise Litigation."

[10] See attached Appendix B entitled "Comment on Industry Statistics."

on the proposed legislation is unfortunate. The proposals have been extensively reported and discussed over the past two years by franchisors, franchisees, their associations, private counsel and academics. Many accommodations have been made. Some important provisions have been extensively adopted by major franchisors on a voluntary basis, proving that legitimate business can prosper while allowing franchisees to obtain desperately needed protection when abuse occurs. Aside from personal attack and strong lobbying, the IFA program has reportedly mounted a major public relations campaign.

The IFA has used many devices. One prime maneuver has been to negotiate for compromise and accommodation, but then to oppose the finally negotiated product. Another has been to mount a "self-regulation" campaign centered on the adoption of a widely advertised Ethical Code of Conduct for all IFA members. A similar ethical code gambit was successfully employed by the IFA in the 1970's to delay and hobble the FTC adoption of the Pre-Sale Disclosure Rule for ten years from 1970 up to its effective date of October 21, 1979.

At the same time, the IFA claims that there is no proven record that calls for the adoption of prophylactic disclosure relief and conduct restriction. The weakness of that attack is demonstrable from the devastating progression of contractual restrictions on franchisees and an imposing list of covenants designed to preclude franchisees from obtaining reasonable access to an impartial tribunal. The Achilles Heel of the IFA Ethical

Code is self-evident in its lack of any meaningful system of enforcement, though the Code declares that violators "are subject to suspension or expulsion from the trade association." The IFA has been challenged as to how franchisees can effectively complain, what procedure is available for an impartial determination, and the real impact of proven violation. The IFA has avoided any offer of an independent private right of action to enforce the Code against any violators.

Among the highlights of the Code is a prohibition of termination without good cause, notice, and a reasonable opportunity to cure. There can be immediate termination for insolvency, abandonment, criminal misconduct, or endangering public health or safety. For starters, if there were to be an effective hearing on each complaint, the IFA would be swamped with cases it could not possibly process. This would especially occur in complex cases where numerous other issues had to be tried. Success would not result in damages or injunctive relief, but simply "suspension or expulsion." By then, the time bar might well have expired.

Non-renewal would be permissible upon expiration: (1) for good cause and 180 days' notice; (2) on 180 days' notice with sale allowed to a qualified party and by the dealer under a different name; (3) without notice for serious violations enumerated for termination; or (4) upon the franchisor's withdrawal from the market. The proposal flatly ignores the substantial fair market value of the dealer's local goodwill in a going business. It provides no other relief. It is subject to the same criticism on

the need for a fair and speedy hearing, without risk of a time bar.

As for a proposed transfer, approval shall not be withheld: (1) if the seller is in full compliance; (2) the vendee meets current qualifications; (3) the transfer terms meet the franchisor's current requirements; and (4) the franchisor waives a right of first refusal. Except for the second requirement, the "conditions" are unfair and inappropriate. The existing franchisee may have had health, money, or business problems, all of which motivated the sale at market value, with the buyer being required to repair all deficiencies. The right of first refusal has been broadly attacked as a dangerous preemptive that can destroy a legitimate sale.

The encroachment standards reveal that no franchisor will ever be found liable since it shall "take into account": (1) the contractual territoriality; (2) the "similarity" of both outlets; (3) whether customers will "be the same"; (4) "competitive activities" in the market; (5) market characteristics; (6) the existing franchisee's ability to "satisfy anticipated demand"; (7) the impact of the new outlet on the old one; (8) the existing outlet's "quality of operations" and physical condition; (9) agreement compliance; (10) the franchisor's "prior experience" in such matters; (11) the effect on the franchise system; and (12) "other relevant information."

This laundry list of factors has been substantially simplified from the long and complex terms of each condition as stated in the Code of Ethics. Assuming that the summary is accurate, the

combined impact would guarantee total freedom for all encroachment. Many of the conditions are irrelevant to justify serious injury or even destruction of the existing dealer's business. Existing and proposed legislation hovers around the "ten percent" impact restriction, a factor that would probably eliminate all future expansion. But the Code would provide justification for all degrees of impact, without recourse for the most egregious of cases.

Any fair litigation of the encroachment standards would be lengthy, costly, and doomed to stalemate even if the franchisor bore the burden of proof. Very few franchisees could conceivably afford to challenge the franchisor's encroachment. The inescapable conclusion is that all restraints on the franchisor would vanish. The hopelessness would equally create the total risk of the franchisor's expressed or implied threat to destroy the franchisee at will. Even enlightened self-interest would not deter the franchisor's drive for increased income from capital fees, royalty on the increased gross sales of both outlets, the sale of goods or services, and incidental income from advertising contributions. Unless the relevant territory could factually support the increased number of outlets, none of the above factors would be dependent on the net profit in any one or more of the existing and encroaching outlets. All of them could fail, leaving a viable string of stores for the franchisor at no cost at all, which it could then operate without the franchisee's built-in handicap and lost investment.

The final Code provision would grant franchisees access to

other sources of supply, but under severe restrictions. The equipment and supplies could not be those which "utilize or embody the franchisor's proprietary information." The third party vendor would have to meet the franchisor's standards, have the capacity to supply the requirements, have a sound financial condition and reputation, and ability to supply enough franchisees to enable the franchisor economically to monitor compliance with standards. These restrictions would require an almost perfect supplier, regardless of the presence or absence of such factors in the franchisor. Many franchisees have been forced to seek alternate sources because of the franchisor's serious deficiencies.

The provision totally ignores the franchisor's ability to impose exorbitant prices for all required products and services, even if this were limited to those with some feigned uniqueness. It is often overlooked that the surest restraint on the franchisor's price gouging is the existence of any credible competitor with a lower price or better quality, the precise goals of federal and state competitive laws.

In the absence of such incentives, the franchisor can freely impose on the family of franchisees an entire array of "free customer services" that materially increase sales at the full cost of the franchisee, compounded by the same fixed royalty on gross sales regardless of the absence of net profit.

The Achilles Heel of IFA's Ethical Code is the lack of any meaningful system of formulating its terms, in its administration, and in its enforcement. There are no established procedures for

fair, speedy, inexpensive and impartial justice. And the overwhelming power of individual franchisors will not only continue, but grow in its ability to stifle complaint.

This shortened overview of the prominent elements in the Code of Ethics reveals a panoply of problems. According to a report in CCH Business Franchise Guide, the strengthened Code was adopted in "an attempt to preempt legal regulation with self-regulation." The IFA declared that "self-regulation is far preferable to over-regulation of franchising by government agencies which would stifle economic growth." In fact, these "toothless" commandments cannot be taken seriously by any franchisor. They would not be accepted by franchisees or their associations except as an offense to their intelligence. Government officials must be quite skeptical.

This overview of recent developments serves a very important purpose for the franchising community. Many courts, legislatures, and regulatory bodies are becoming better acquainted with this comparatively new force in the market place. The hidden facets of this distribution method are more often being subjected to the sanction of the bright light and sunshine catharsis formulated almost a century ago in Louis D. Brandeis' book "Your Money and What the Bankers Do With It." Franchising will be the better for it.

LAW OFFICES OF

HAROLD BROWN

AREA CODE 617
720-4200
FAX 720-0240

HAROLD BROWN
L. MICHAEL HANKES
LINDA J. KEOGH
CATHERINE M. KEENAN
JAMES A. JANDA
ROBERT L. DOUCETTE
BONNIE AARONSON

66 LONG WHARF
BOSTON, MASSACHUSETTS 02110-3610

OF COUNSEL:
L. SETH STADFELD

April 29, 1993

The Honorable John J. LaFalce
House of Representatives 103d Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, D.C. 20515-6315

Re: Franchise Legislation

Dear Congressman LaFalce:

I would appreciate your adding to the record the enclosed copy of an article that appeared in Nations Restaurant News on December 21, 1992 at page 3. In his article on Cajun Joe's, reporter Peter O. Keegan stated:

> "the chain (Cajun Joe's) went from seven units in 1989 to 150 units in 1991, opening three per week and ultimately selling 400 franchises altogether. The chain peaked quickly, but has slid nearly as fast, with many franchisees failing in the process.
>
> Today the chain has approximately 70 units, and franchisees hoping to recoup losses from failed stores and are reportedly pondering a lawsuit."

In my presentation to your subcommittee, I indicated that approximately 150 Cajun Joe's franchises had been sold of which 100-125 had failed. These later figures show that Cajun Joe's ultimately sold 400 franchises of which 330 had failed. There is no doubt that the number of failures has increased since the publication of the article on December 21, 1992.

Sincerely,

Harold Brown

Harold Brown

HB/ap

Nation's Restaurant News
THE NEWSWEEKLY OF THE FOODSERVICE INDUSTRY ®
SECOND CLASS
Vol. 26, No. 51 · Published every Monday by Lebhar-Friedman Inc., $5 per issue · December 21, 1992

Cajun Joe's co-president exits struggling chain

by Peter O. Keegan

MILFORD, Conn. — Cajun Joe's namesake and co-president, Joe Barrett, has quit the company and moved to Florida, apparently frustrated by widespread franchisee discontent and recurring sales problems.

"He decided that he'd had enough," said Cajun Joe's remaining president Richard Cromwell, who, along with Barrett, founded the chain in 1985. Asked about reports that Barrett has lost everything and may seek personal bankruptcy, Cromwell replied, "As of today, that's not true. I don't know if he's going to or not."

Barrett's departure comes at a time when Cajun Joe's is fighting to overcome sales and profit problems which franchisees blame on overexpansion.

Bringing spicy fried chicken and Cajun specialties to a region that previously had very little exposure to it, Barrett and Cromwell started in Boston, successfully building the operation to seven restaurants before it caught the eye of Subway franchising czar Fred DeLuca.

DeLuca bought a controlling interest in the chain in 1989, calling it a "good growth vehicle for Subway franchisees," and pitched it to them as the next "hot" franchising alternative.

Suddenly, with DeLuca behind it, the chain went from seven units in 1989 to 150 units in 1991, opening three per week and ultimately selling 400 franchises altogether. The chain peaked quickly, but has slid nearly as fast, with many franchisees failing in the process.

Today the chain has approximately 70 units, and franchisees hoping to recoup losses from failed stores are reportedly pondering a lawsuit.

Cromwell admitted in retrospect that one of the concept's failings was that it opened in many different areas without concentrating on regional strengths. "If I had to do it all over again, I would have developed it on a concentric circle basis," Cromwell said. "You build from a sphere of influence, where circles keep getting larger."

Franchisees — many with no foodservice experience — opened in cities across the board without enough marketing and purchasing efficiencies to battle the competition, and with the product and equipment mix constantly changing — costs went up as sales fell.

"We've tried a lot of changes in the past to fix the problems but created more problems for ourselves," admitted Cromwell. "Sometimes you should leave well enough alone."

In a recent telephone survey of franchisees from 1991, NRN found that all seven units in Pennsylvania were shuttered, all three Cajun Joe's in Rhode Island had closed and six out of nine units in Massachusetts, including the duo's original unit in the Mission Hill district, had been shut down.

"Some were stores that people just didn't have the capital to hang onto — and some lost enthusiasm," explained Cromwell. "We've lost a lot of money ourselves. Right now we want to get the stores working right and assess where we are. If we choose to go back into development, we will do it slowly and thoughtfully."

Meanwhile, a group of franchisees have banded together, led by former franchisee George Peck of Altamonte Springs, Fla., whose store lasted six months.

"They went hog wild and grew too fast," Peck said. "The concept didn't work; it's an economic disaster. The overhead was too high, we had to buy spices from them which were too expensive and they changed the product and equipment lines a dozen times."

"Our office has been engaged to study the matter," said Boston lawyer Harold Brown, who has his own practice. "There do appear to be some serious questions, since there have been a rather large number of failures."

Cromwell said the company is looking at other alternatives to offer franchisees, such as the Q Burger hamburger franchise. "That hasn't taken off," said Cromwell. "If it did, we would offer it to franchisees."

"Right now we are concentrating anywhere that we have stores," said Cromwell.

"We are helping owners by providing ad support out of pocket and rebates on royalties. We have a few [franchisees] that aren't paying and we are not trying to evict them. We are trying to make these guys successful," he added.

Cromwell said that store closings are slowing down a bit and that per-store sales were up compared to last year's. "Anytime sales go up, that will help people make money, or get them closer to making money," he said.

LAW OFFICES OF

HAROLD BROWN

AREA CODE 617
720-4200
FAX 720-0240

HAROLD BROWN
L. MICHAEL HANKES
LINDA J. KEOGH
CATHERINE M. KEENAN
JAMES A. JANDA
ROBERT L. DOUCETTE
BONNIE AARONSON

66 LONG WHARF
BOSTON, MASSACHUSETTS 02110-3610

OF COUNSEL:
L. SETH STADFELD

April 27, 1993

The Honorable John J. LaFalce
House of Representatives 103d Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, D.C. 20515-6315

Dear Congressman LaFalce:

I want to thank you again for allowing me to testify before your subcommittee.

With regard to the dealers' right of free association and negotiation, I would appreciate your putting in the record the enclosed copy of pages 811-816 of my law review article entitled "A Bill of Rights For Automobile Dealers," 12 Boston College Ind. and Com. L. Rev. 757 (1971). It deals with your fundamental proposal that would preclude a franchisor from interfering with the right of its franchisees to negotiate jointly with the franchisor.

Sincerely,

Harold Brown

Harold Brown

HB:jad

deceptive practices" in Section 3(a) of the Act, and the broad definition of "fraud" in Section 1(m), as including misrepresentation, "whether intentionally false or due to gross negligence, a promise or representation not made honestly and in good faith, and an intentional failure to disclose a material fact," the Act appears to impose requirements of fullest disclosure in connection with any "franchise offering." There is considerable doubt that any of the factories have ever met such standards with respect to disclosing to prospective dealers the numerous practices of which existing dealers complain, whether "operating," "capital," or "administrative" in nature.

2. *Provision for Compensation to Dealers*

Section 9 of the new Massachusetts Act[271] provides that if "without due cause" the manufacturer fails to renew, terminates or restricts a transfer of a dealership, the dealer must "receive fair and reasonable compensation for the value of the business." As simple as the justice of this formula would appear, it will bring to an end the manufacturers' practice of ignoring the dealer's contribution to the goodwill of the dealership, and their prior policy of prohibiting the dealer from charging a purchaser for this asset in a sale of the dealership. Goodwill is universally recognized as a valuable, though intangible, asset of any going business. Significantly, this alternative to the dealer's right to seek injunctive relief against termination of a dealership, was the ultimate focus of the manufacturers' opposition to adoption of the Massachusetts Act. Perhaps the unspoken reason for their adamant opposition to this section is its implicit restraint on the market restructuring abuses discussed above.[272]

3. *Dealers' Right of "Free Association"*

Section 10 of the Massachusetts Act[273] provides that "[e]very franchisee shall have the right of free association with other franchisees for any lawful purpose." Given the furor which preceded the adoption of the National Labor Relations Act[274] and its counterpart in Massachusetts, the State Labor Relations Law,[275] it may be open to question

Steak, Inc., — F. Supp. —, Civil No. C-1787 (D. Colo., decided Sept. 30, 1970) (holding that a fast-food franchise is not a "security" under the federal securities acts); Abercrombie v. Lum's, Inc., — F. Supp. —, Civil No. 295-70-A (E.D. Va., decided April 12, 1971) (holding that franchise agreements were not "investment contracts" subject to the securities acts). Where the auto manufacturer sells the dealer securities representing a fractional interest in an auto dealership, under some form of a dealer development program, there would appear to be no doubt as to the applicability of SEC Rule 10b-5.

271 Mass. Gen. Laws Ann. ch. 93B, § 9 (4 Mass. Leg. Serv. 716-17 (West 1970)).

272 See discussion on pp. 768-69 supra.

273 Mass. Gen. Laws Ann. ch. 93B, § 10 (4 Mass. Leg. Serv. 717 (West 1970)).

274 29 U.S.C. §§ 151-68 (1964).

275 Mass. Gen. Laws Ann. ch. 150A, §§ 1-12 (1958), as amended, (Supp. 1971). Many other states have enacted similar statutes.

whether the auto dealers have obtained a material right under this provision, particularly since earlier drafts of the new Massachusetts Act would have specifically accorded the dealers the full panorama of collective bargaining rights contained in the State Labor Relations Law, including the separate statute governing the use of arbitration as a method of settling disputes.[276] In the absence of such a specific recognition of collective bargaining rights, the limiting phrase in the new Act, allowing dealers the right of free association "for any lawful purpose,"[277] appears to beg the question. Nevertheless, it is apparent that a substantive achievement is embodied in the phrase "right of free association with other franchisees," and that the necessity of giving meaning to those words calls for limited construction of the restriction "for any lawful purpose." Resort to the historical background of the statute and a clear appreciation for the purposes underlying it should provide some basis for its meaningful interpretation. In this connection it should be noted that a fundamental inconsistency confronting all franchisees is the fact that, while conceptually and theoretically they are independent businessmen, in fact they are subject to so many economic and legal burdens that their status is not substantially different from that of employees. As aptly expressed by a Canadian court in the recent case of *Jirna, Ltd. v. Mister Donut of Canada, Ltd.*:[278]

> It appears to me that the relationship between the franchisor and the franchisee in the case at bar is much more than a simple vendor-and-purchaser relationship. In some respects it has at least some of the attributes of a partnership. To the extent that the arrangement requires the franchisor to purchase all supplies from persons of its own choosing, a principal-and-agency relationship has been established. Certainly, what has been created is a very close association, a venture in common, or a joint venture. If that be so, then what may be described as fiduciary obligations or at least *quasi*-fiduciary obligations, have been created.[279]

The court further observed:

> In this particular type of relationship, it appears to me that franchisor and franchisee are bound together over a very long period of years in a relationship which in many re-

[276] Mass. Gen. Laws Ann. ch. 150C, §§ 1-16 (Supp. 1971). Full collective bargaining rights would be accorded to all franchisees under Senate Bill 110, currently under consideration by the Massachusetts Legislature. See note 158 supra.

[277] Mass. Gen. Laws Ann. ch. 93B, § 10 (4 Mass. Leg. Serv. 717 (West 1970)). See discussion in note 59 supra.

[278] 3 Ont. 629 (1970) (currently under appeal).

[279] Id. at 637.

spects is almost as close as that of master and servant. While of course it is not the same, nevertheless the relationship is so close that confidence is necessarily reposed by the one in the other.[280]

Similarly, in spite of the contractual terms of the franchise, the National Labor Relations Board (NLRB) has held that some franchisees are in fact "employees" within the statutory definition of the Wagner Act.[281] In January, 1969, the Labor Court of Sweden held that the gasoline station dealers of Esso were entitled to collective bargaining rights in view of the dominant economic power of the oil company and the control inherent in the fact that the dealers had to look to the company as their sole source of supply.[282]

On the technical side, to the extent that franchisees are regarded as independent businessmen, collective activity can be perilous. For example, when the International Teamsters Union tried to organize a number of gasoline station dealers in California several years ago, their activity was successfully attacked as a common law criminal conspiracy,[283] much as were the seminal attempts to organize labor unions in the 1920's.[284] In a recent case before the FTC, the National Association of Women's and Children's Apparel Salesmen was charged with being an illegal combination of independent businessmen under the Clayton Act, the Association contended that it is a labor organization, and thus not subject to the jurisdiction of the FTC. The FTC, however, admitted as part of the record of its proceedings, a recent decision by the NLRB disqualifying the Association from acting as a labor organization, despite the fact that the NLRB decision was subject to appeal.[285] Nonetheless, out of "deference" to the NLRB's ruling, the FTC found that the labor antitrust exemption was not available to the Association.[286]

There is also the potential risk that even acting as independent businessmen, a so-called "strike" by a group of franchisees would

---

[280] Id. at 640-41.

[281] 29 U.S.C. §§ 201-19 (1964). See, e.g., Mister Softee of Indiana, Inc., 162 N.L.R.B. 354, 64 L.R.R.M. 1034 (1966); News Syndicate Co., Inc., 164 N.L.R.B. 422, 65 L.R.R.M. 1104 (1967); cf. The Southland Corp., 170 N.L.R.B. No. 159, 67 L.R.R.M. 1582 (1968).

[282] As reported in Gasoline Retailer, vol. 68, no. 1, Jan. 7, 1970, at 3.

[283] Since none of the convictions were appealed the cases are unreported.

[284] See, e.g., American Steel Foundries v. Tri-City Central Trades Council, 257 U.S. 184 (1921); Hitchman Coal & Coke Co. v. Mitchell, 245 U.S. 229, 250-51 (1917).

[285] National Ass'n of Women's and Children's Apparel Salesmen, Inc., [1967-1970 Transfer Binder] Trade Reg. Rep. ¶ 19,016 (FTC 1969).

[286] National Ass'n of Women's and Children's Apparel Salesmen, Inc., 3 Trade Reg. Rep. ¶ 19,538 (FTC 1971). For the NLRB's decision see Bambury Fashions, Inc., 179 N.L.R.B. No. 75, 72 L.R.R.M. 1350 (1969).

constitute a per se boycott violation under the antitrust laws.[287] In the labor relations context, that very risk led to the need for exemption of labor disputes from the impact of the antitrust laws.[288] But even that exemption was held insufficient to shield the action of numerous brokerage firms which jointly imposed uniform reductions in the commissions paid to their "employee-representatives."[289] In this circumstance the statutory exemption was held to require either the existence or the prospect of a joint collective bargaining agreement with a union.

Historically, auto dealer associations have been of several types, with varying purposes and efficacy. At the national level, the National Automobile Dealers Association draws its members from individual dealers of all the manufacturers, having neither direct nor affiliative connections with state and other groups. Although its membership is substantial and it maintains a full-time staff, including legal counsel to contest challenges to state legislation benefitting auto dealers, it has been criticized as being too unwieldy to act in an expeditious and effective manner. Within its limitations, however, it has afforded considerable assistance to dealers, most recently in its successful educational campaign to induce the Big Three to forego subsidies to leasing and fleet buyers, and through its financial support of a pending test case on this question against Chrysler.[290] As previously noted, Chrysler has claimed that this financial support is itself evidence of a combination in restraint of trade on the part of the dealers of the other manufacturers.

In most states, there are associations of the dealers of all the manufacturers, some of the larger states having two such organizations. While it is impossible to evaluate the individual effectiveness of so many entities, it is known that some have acted vigorously in various areas, particularly in the legislative sphere, while others have been little more than social clubs. In at least one instance, an association has reverted to coordinating group insurance plans as its principal activity, and has expressly terminated all lobbying efforts as a threat to its non-profit corporate charter and its tax-exempt status.

More recently, there have arisen a number of so-called "line" associations, confined to the dealers of a particular manufacturer and usually active in a limited geographical area. As a result of strong leadership, tight membership and common problems, arising from the

---

287 See Klor's, Inc. v. Broadway-Hale Stores, Inc., 359 U.S. 207 (1959).

288 15 U.S.C. § 17 (1964).

289 Cordova v. Bache & Co., Inc., 321 F. Supp. 600, 5 Trade Reg. Rep. ¶ 73,406 (S.D.N.Y. 1970). Interestingly, the court also held that although the employees' association was not a proper party plaintiff, it would permit individual employees to be substituted as plaintiffs. Id. at 608, 5 Trade Reg. Rep. ¶ 73,406, at 89,657.

290 See discussion at p. 775 and note 54 supra.

fact that all members deal with the same manufacturer, these associations have been rather vocal in their demands for radical changes in the factory-dealer relationship. The independence of such "line" associations affords a marked contrast to the ineffectiveness of the regional "Dealer Councils" created by the individual manufacturers and consisting of dealers elected by other dealers. One possible reason for the general ineffectiveness of such councils is their close identity with the individual manufacturer. In addition, the long history of procrastination, protracted studies, and ultimate inaction on the part of the manufacturers in response to suggestions from the councils offers little by way of hope for future improvement. Ford's recent effort, discussed earlier,[291] to invigorate this program by providing regionally selected dealer groups to review individual dealer complaints, appears specious in the absence of any firm commitment on the part of Ford to abide by the decisions of these panels.

Technicalities aside, it seems evident that genuine collective bargaining by franchisees provides the only realistic hope for an effective franchising relationship. Even those who doubt the need for such collective bargaining would doubtless find that mechanism for the resolution of dealer grievances preferable to the cataclysmic alternative of treble damage class antitrust suits, involving claims of $100 million or more. Interestingly enough, during the pendency of such suits counsel for the dealers and the factory may engage in a form of "collective bargaining" to settle the claims, subject to the provisions of Federal Rule 23, requiring court approval of any settlement after formal notice to all members of the class. To avoid the necessity of such "back-door" collective bargaining, the author has recommended to the FTC that it promulgate regulations or propose legislation to permit such bargaining without the disruption, expense and delay inevitably entailed in antitrust litigation.

Permeating this entire issue is the gross imbalance between the relative bargaining positions of the individual franchisees and the franchisors, particularly where the franchisors are economic giants, such as the auto manufacturers or the major oil firms. Although labor groups may decry the comparison, the fact remains that the greater the franchisee's investment of money and labor in his dealership, the greater is his fear for the consequences of standing up for his rights. In contrast, the non-unionized employee who is unhappy with his lot, at least has the options of resigning or of joining in an effort to obtain collective representation. Given both the impossibility of legislating against every conceivable abuse in every franchising industry, and the unsuitability of litigation as a means of resolving conflicts in a dy-

[291] See discussion at pp. 773-74 supra.

namic and continuing joint enterprise, the courts should not prove insensitive to the compelling social need for permitting collective efforts on the part of franchisees. Such judicial sanction would be consonant with the public policy underlying the antitrust laws themselves, namely the preservation of competition through the conservation of one of the most essential elements in the competitive formula —the small, but independent, businessman.

D. *Sanctions Under the Massachusetts Act*

1. *Civil Penalties and Injunctions*

Adhering to the pattern of the federal antitrust laws, the new Massachusetts Act provides heavy penalties in support of its provisions. Section 12 of the Act[292] assigns to the Attorney General the primary duty of enforcement, incorporating by reference the extensive powers granted to him in the "Baby" FTC Act.[293] Those powers include such matters as the right to obtain both temporary and permanent injunctions,[294] including a civil penalty of not more than ten thousand dollars for each violation;[295] the power to accept assurance of discontinuance and voluntary payment of the costs of investigation or to compel the creation of an escrow fund for restitution to aggrieved persons;[296] and extensive investigatory powers, including the power to examine records,[297] the power to subpoena witnesses,[298] and the power to take testimony under oath.[299] Finally, to aid in obtaining information, the statute declares any information acquired under its authority to be inadmissible in a criminal prosecution for "substantially identical transactions,"[300] and establishes a fine of not more than five thousand dollars for failure to appear to give testimony or for wilfully destroying documentary evidence in order to evade an investigation.[301] Punishment for contempt of court is also available for non-compliance with a court order issued in support of the Attorney General's investigatory powers.[302] For habitual violations of injunctions against practices prohibited under the Act, the Attorney

292 Mass. Gen. Laws Ann. ch. 93B, § 12 (4 Mass. Leg. Serv. 717 (West 1970)).

293 Mass. Gen. Laws Ann. ch. 93A, §§ 4-8 (Supp. 1970).

294 Mass. Gen. Laws Ann. ch. 93A, § 4 (Supp. 1970). By way of contrast, the FTC is not yet empowered to obtain temporary injunctions, a fact which may account for its inability to act expeditiously, particularly in the area of false advertising.

295 Mass. Gen. Laws Ann. ch. 93A, § 4 (Supp. 1970).

296 Mass. Gen. Laws Ann. ch. 93A, § 5 (Supp. 1970).

297 Mass. Gen. Laws Ann. ch. 93A, § 6(1)(b) (Supp. 1970).

298 Mass. Gen. Laws Ann. ch. 93A, § 6(1)(c) (Supp. 1970).

299 Mass. Gen. Laws Ann. ch. 93A, § 6(1)(a) (Supp. 1970).

300 Mass. Gen. Laws Ann. ch. 93A, § 6(7) (Supp. 1970).

301 Mass. Gen. Laws Ann. ch. 93A, § 7 (Supp. 1970).

302 Mass. Gen. Laws Ann. ch. 93A, § 7 (Supp. 1970).

New York Law Journal

NEW YORK, THURSDAY, OCTOBER 28, 1993

FRANCHISING

HAROLD BROWN

A Look at Proposed Legislation

THERE HAS BEEN a strong surge of proposed federal and state legislation to strengthen pre-sale disclosure to prospective franchisees and to improve franchisor conduct controls.[1] The International Franchise Association (IFA) has consistently opposed all federal and state legislation both directly and by proposals to restrict their terms or to postpone their enactment. When pressed, it has devised voluntary standards as an expressed substitute.

Since its organization in the early 1960s the IFA has developed into the strongest franchisor association, with more than 2,500 members. In spite of its name, the association has not accepted membership for franchisees or their associations. To defeat or delay legislative proposals, it has adopted a multi-prong attack. It has now made a total turnabout by deciding to invite franchisees and their associations to join it.

Such an invitation raises issues of direct conflict with those who join the IFA. Questions exist whether franchisees will be able to vote, attain executive office, become governing delegates and exercise influence in policy formulation and administration. A prime issue will be the conflict of interest in the IFA's legislative policies, its nationwide opposition to all legislation and regulation to protect franchisees and the expenditure of millions of dollars from its general income in lobbying directly and through political action committees against legislative protection of franchisees' rights. Such a direct conflict of interest would appear to constitute a breach of trust and possibly outright fraud in any use of the franchisees' dues and other contributions for such purposes.

Proposed Legislation

On the federal front, on March 11, Representative John LaFalce, D-N.Y., re-introduced three bills to strengthen pre-sale disclosure (HR 2596, 102d Cong., 2d Sess.), to control the franchisor's conduct (HR 2593, 102d Cong., 2d Sess.), and to require the provision of essential data to a government agency (H.R.2595, 102d Cong., 2d Sess.). These bills carried strong support from more than a dozen representatives.

At the state level, a relationship termination bill was introduced in the South Dakota legislature on Jan. 27, patterned on the all-inclusive 1992 Iowa statute passed.[2] In addition to the familiar "good cause" restrictions against termination, and nonrenewal, So. Dak. House Bill No. 1256 would impose a mutual statutory duty of good faith; permit acquisition of equipment, supplies, and services from outside sources; prohibit denial of transfer without good cause, and bar encroachment within "an unreasonable proximity" of an established franchise.

This year, similar public policy proposals were offered for restaurant franchisees in Texas (S. No.195) and Arkansas (S. No.227). The Texas measure was a relationship-termination law that also created a private remedy for the franchisor's failure to comply with the Federal Trade Commission's pre-sale disclosure rule. In addition to other restrictions, it expressly barred encroachment "within such proximity as would cause an 8 percent or more reduction in gross sales in any month during the next 24 months." The Arkansas "procedural fairness" measure prohibited contractual provisions purporting to apply extra-state laws to local businesses or a contractual choice of extra-state venue. It was expressly "declaratory of public policy" and "intended to apply to franchises granted, transferred, renewed, or in existence on or after the law's effective date." A Washington bill (H. No. 1698) would amend already strong franchise legislation to prohibit discrimination between franchisees on the basis of "race, creed, color, national origin, sex" or the presence of any broadly specified physical handicap. Similar legislation has been introduced in the current sessions in at least a dozen other states.

All of these proposals are much broader than the general run of legislation enacted in the 1970s and early 1980s. The recent bills demonstrate that all across the country federal and state legislatures have become acutely aware of the need for further disclosure and conduct control. Undoubtedly that awareness has been the response of both legislatures and executives to the intense effort of the North American Securities Administrators Association (NAASA), an organization consisting of the administrators of franchise registration statutes in states and Canadian provinces.

The NAASA proposals included a broad revision of the presale disclosure regulation, particularly including authorization for cooperation by the states in administration and enforcement. NAASA also completed an extensive revision of the Uniform Franchise Offering Circular (UFOC) after more than three years of intense deliberations. For a time, NAASA also considered a broad revision of conduct control legislation, but that has been set aside for now to focus on the pre-sale disclosure matters.

IFA Opposition

These legislative efforts have been a prime target for IFA opposition. The opposition includes political attack on the legislative proponents in their home districts. The lobbying has been accompanied by a major public relations campaign against all such legislative proposals, both in Congress and in state capitals. The IFA has used many devices. A prime maneuver in committee sessions has been to seek compromise and accommodation but then to oppose the negotiated product. Another has been to mount a "self-regulation" campaign centered on the IFA's adoption of a widely advertised Ethical Code of Conduct for all members. A similar ethical code gambit was successfully employed by the IFA in the 1970s to delay and hobble the FTC adoption of the Pre-Sale Disclosure Rule for 10 years, until it took effect Oct. 21, 1979.

At the same time, the IFA claims that there is no proven record that calls for the adoption of prophylactic disclosure relief and conduct restriction. The weakness of that attack is demonstrable from the massive progression of franchise agreement restrictions on franchisees' assertion of fundamental procedural and substantive rights. These include various combinations of contractual choice of distant venue; of arbitration costing tens of thousands of dollars in fees, instead of a $120 filing fee in a federal

court; of a short time bar of six months to a year within which to sue; of waiver of jury trial; of consenting to a finding of irreparable damage as a prerequisite for injunctive relief; of requiring exhaustion of arbitration against the franchisor before being allowed to sue related individuals and corporations in court; of assessing losers for attorneys fees and costs; of consenting to a bar of class proceedings, consolidation, and other legal devices to obtain speedy and inexpensive justice, and of precluding the arbiter from awarding punitive and certain other forms of common law damages.

In its opposition to the standard of good faith and fair dealing, a major fast-food franchisor bluntly told the court that it could not continue to manage its extensive franchise system if franchisees were able judicially to challenge its actions under the prohibition of bad faith.[3]

The Achilles heel of the IFA Ethical Code is self-evident in its lack of any meaningful system of enforcement, although the code declares that violators "are subject to suspension or expulsion from the trade association." The IFA has been challenged onhow franchisees can effectively complain, on what procedure is available for an impartial determination and on the real impact of proven violation. The IFA has declined to offer either an independent private right of action to enforce the code against any violators or a suspension of statutory time bars during the proceedings.

Termination Reasons

Among the highlights of the code is a prohibition of termination without good cause, notice and a reasonable opportunity to cure. There can be immediate termination for insolvency, abandonment, criminal misconduct or endangering public health or safety. For starters, if there were to be an effective hearing on each complaint, the IFA would be swamped with cases it could not possibly process. This would especially occur in a complex suit where numerous other issues had to be tried. Success would not result in damages or injunctive relief, but simply in "suspension or expulsion" of the franchisor from the IFA. By then, the statutory time bar might well have expired.

Under the code, nonrenewal would be permissible upon expiration of the franchise agreement: (1) for good cause and 180 days' notice; (2) on 180 days' notice with sale allowed to a qualified party and by the dealer under a different name; (3) without notice for serious violations enumerated in the contract for termination; or (4) upon the franchisor's withdrawal from the market. That carefully worded standard is replete with pitfalls.

The proposal relies on the unrestricted and unfair list of grounds for termination enumerated in the particular franchisor's contract of adhesion unilaterally drafted by the franchisor and its corps of highly sophisticated counsel long before its presentation to the prospective franchisee without any realistic opportunity for him to negotiate its harsh terms. On renewal, the franchisee is virtually helpless to save an existing business unless he submits to the unlimited opportunistic conduct of the franchisor.[4] The code provides no real protection for the substantial fair market value of the dealer's local goodwill in a going business.

Those concerns have led many legislatures to prohibit nonrenewal except for good cause. The code provides no other relief. It is also subject to the same criticism for its lack of a fair and speedy hearing, without risk of expiration of a statutory time bar.

As for a proposed transfer, the code declares that approval shall not be withheld: (1) if the seller is in full compliance; (2) the vendee meets current qualifications; (3) the transfer terms meet the franchisor's current requirements; and (4) the franchisor waives a right of first refusal.

Examination of most franchise agreements and their companion Confidential Manual of Operations discloses that "full compliance" is a virtual impossibility. Many of the current requirements and "conditions" are grossly unfair, inappropriate and unattainable with the usual caliber of low-paid employees. Even if there were some defaults, they may have arisen from a variety of understandable causes like health, money or business problems, all of which motivated the sale at market value. Approval of the transfer should simply state that the buyer will be required to repair the specified defaults and deficiencies. The franchisor should have no complaint if the buyer repairs defaults, presumably at the seller's expense.

As for the right of first refusal, that facially simple prerogative has been broadly attacked as a dangerous preemptive that can delay, chill or destroy the franchisee's opportunity to make a legitimate sale to a willing and qualified buyer. Such interference can transform the buyer into a customer to whom the franchisor wants to sell a franchise. The franchisor will avoid disclosure that the new franchise is not a bargain because it is new or in a marginal or virgin territory with neither local nor national name recognition or goodwill.

The encroachment standards are so strict that no franchisor has to be concerned about possible liability. The code declares that the franchisor may "take into account" all of the following: (1) the contractually specified territory; (2) the "similarity" of both the original and the proposed outlets; (3) whether customers will "be the same" for each outlet; (4) "competitive activities" in the market; (5) market characteristics; (6) the existing franchisee's ability to "satisfy anticipated demand;" (7) the anticipated impact of the new outlet on the old one; (8) the existing outlet's "quality of operations" and physical condition; (9) the franchisee's record of contract compliance; (10) the franchisor's "prior experience" in such matters; (11) the over-all effect on the franchise system; and (12) "other relevant information."

That laundry list of factors has been substantially simplified from the long and complex terms of each condition as stated in the Code of Ethics. The combined impact guarantees the franchisor's total freedom from any liability for encroachment. Many of the conditions are irrelevant to justify the serious injury or even destruction of the existing dealer's business. Existing and proposed legislation hovers around the "10 percent" impact restriction, a factor that would at least provide a modest area of protection without seriously impeding the franchisor's market penetration. But the code would provide justification even for the severest degree of impact by the franchisor's encroachment, without any recourse for the franchisee against the most egregious cases.

Under the specified standards, the franchisor would not be responsible for bad faith, for vindictive aggression or for opportunistic conduct to satisfy the franchisor's economic benefits regardless of the consequences for the impacted franchisee. Any fair litigation of such encroachment standards would be lengthy, costly and doomed to stalemate even if the franchisor bore the burden of proof. Very few

franchisees could afford to challenge the franchisor's encroachment. The inescapable conclusion is that all restraints on the franchisor would vanish.

The hopelessness of the franchisee's objections would arise from the total risk of the franchisor's expressed or implied threat to destroy the franchisee at will. Even enlightened self-interest would not deter the franchisor's drive for increased income from capital fees, royalty on the increased gross sales of both outlets, the sale of goods or services, incidental income from advertising contributions, and cutting back on the modest protection the franchisee had secured. Unless the relevant territory could factually support the increased number of outlets, none of the franchisor's goals would be dependent on the net profit for any one or more of the existing and encroaching outlets.

Both the new and old units could fail because the area could not support both. It would, however, leave a viable string of stores for the franchisor to recapture for little or no compensation for capital improvements and goodwill. The successor "company" store would not have the burdens of paying royalties and many other fees. The franchisor would be free to choose the most profitable stores for reacquisition and to sell the remaining repossessed stores to yet another franchisee.

Sources of Supply

The final code provision grants franchisees access to other sources of supply of capital and inventory goods, but it does so under severe restrictions. The equipment and supplies could not be those that "utilize or embody the franchisor's proprietary information." Such a trade secret could easily be feigned or simply be a pretext by slightly altering a sauce or spice package. In addition, the code says that the proposed third-party vendor would have to meet the franchisor's standards, have the capacity to supply the market's requirements, have a sound financial condition and reputation and demonstrate its ability to supply enough franchisees to enable the franchisor economically to test and monitor compliance with its standards.

These restrictions would require an almost perfect supplier, regardless of the presence or absence of such factors in the competing franchisor. In fact, many franchisees have been forced to seek alternate sources of supply because of the franchisor's serious financial problems, poor products, extra distance from the point of usage and inability to provide adequate products for the franchisee's needs. When such a shortage exists, the company stores have first choice on supplies and the preferred models.

The alternate supplier provision totally ignores the franchisor's ability to impose exorbitant prices for all required products or services, even those with some feigned uniqueness. It is often overlooked that the surest restraint on the franchisor's price gouging is the existence of any credible competitor with a lower price or better quality, the precise goals of federal and state competitive laws.

In the absence of such incentives, the franchisor can freely impose on the family of franchisees an entire array of "free customer services" that will materially increase sales at the entire expense of the franchisee, compounded by the same fixed royalty on gross sales regardless of the amount or the absence of net profit.

As noted, the fatal flaw of the IFA's Ethical Code is its lack of any meaningful system of formulating its terms, in its administration and in its enforcement. There are no established procedures for fair, speedy, inexpensive and impartial justice. And the overwhelming power of individual franchisors will not only continue, but will grow in its ability to stifle complaint by injured franchisees.

This shortened overview of the prominent elements in the IFA's Code of Ethics reveals many problems. According to a report in CCH Business Franchise Guide, the strengthened Ethical Code was adopted in "an attempt to preempt legal regulation with self-regulation." The IFA declared that "self-regulation is far preferable to over-regulation of franchising by government agencies which would stifle economic growth." In fact, these "toothless" commandments cannot be taken seriously by any franchisor. They will not be accepted by franchisees or their associations except as an offense to their intelligence. Government officials will be quite skeptical.

Mediation Program

The IFA has added a mediation program to its anti-legislation campaign. It selected a mediation organization that was formed several years ago by a large group of major corporations with their mutual pledge to mediate for a specified time before suing each other. The mediation group has a stellar record of performance, executive management and a corps of participating mediators. Its major activities have involved large companies of substantially equal bargaining power and access to professional representation.

Such mediation has many attractions — confidentiality, speed, low cost, an impartial go-between and the prestige to fashion or induce a compromise settlement that might not be available in court. Its use in franchise relations nonetheless involves a variety of significant issues. Most of the problems stem from the gross imbalance in the franchise relationship.

For many years, prominent franchisors have used mediation in a variety of established arrangements. General Motors has provided its auto dealers with so-called arbitration in which the company is bound by the award, but the auto dealer is not bound, thereby making it a hybrid mediation procedure. Unfortunately, the record of performance is extremely poor with only a handful of cases ever resulting in a finding for the auto dealer. McDonald's has used an ombudsman technique in which it selects a current or former company official to act as a mediator together with a franchisee whose business is similar to that of the claimant in the dispute.

The mediators have total freedom to obtain facts from the franchisee and the company, then to render their decision. The franchisor does not, however, consider itself bound by the result. The nation has hundreds of mediation groups available in every city and town, often as an adjunct to courts. Each of the systems has some attraction, but franchisees may not be well served.

In mediation, the franchisee is seldom in a position to know the relevant facts and the applicable laws. It cannot be assumed that the mediator will be in a better position. To get the facts, the dealer must have access to the franchisor's documents and reports related to the case. The dealer must also have a reasonable opportunity to obtain counsel, to have the claims analyzed and to be professionally represented.

During the mediation, some of the dealers's legal rights may become time-barred under the applicable statute of limitations. To prevent this, the franchisor should be required to waive the statute of limitations until a specific period after the conclusion of the mediation.

A prime issue involves consideration of overly restrictive and possibly illegal parts of the franchise agreement. These may include contractual choice of venue and law and the method of adjudication. Each of these matters has been the subject of complex legal controversy, particularly as to "choice of law" where the selected law is contrary to "fundamental public policy" in the franchisee's jurisdiction.

There are many statutory and common law restrictions on franchise agreements, particularly where they seek to take away legal rights protected by disclosure and conduct statutes; where they are superseded or subject to interpretation under the principles of good faith and fair dealing; where independent rights derive from "little" Federal Trade Commission Act statutes prohibiting "unfair or deceptive acts or practices"; where federal or state Racketeer Influenced and Corrupt Organizations Act statutes provide private relief for felonious type conduct, especially mail or wire fraud; where federal and state antitrust laws supersede contrived contractual deals; and under myriad common law legal principles.

The latter include restrictions on penalty clauses that now proliferate; on forfeitures; on unconscionability, and on public policy restrictions. In spite of these many limitations on contracts, particularly in those of adhesion, the franchisee is seldom able to protect such valuable rights because of the mediator's reliance on the enforcement of express covenants in a contract of adhesion and the franchisee's inability to compel the franchisor to accede voluntarily to serious charges.

Joining Forces

In the procedural realm, one of the most significant protection for franchisees, is the right to act together with other similarly situated franchisees. They need to join forces in order to raise the funds for professional services; to negotiate terms for their almost uniform business treatment, conduct, and claims; and to corroborate each other's evidence on conduct, oral statements, and competitive factors. In many federal and state statutes, the access to exemplary damages may hinge in part on proof of the franchisor's repetitive misconduct. Where matters are not technically joined as class suits, they need the right to consolidate their claims and to rely on offensive collateral estoppel to avoid many rehearings and the risk of inconsistent findings by independent tribunals.

Where damages are sought, the franchisee needs the support of qualified experts to assemble and interpolate all the reasonably available data. Similar skills are be needed to formulate punitive or statutory exemplary damages. They need to pool their assets to afford such economic experts and their professional individualized computations based on the applicable formulas.

Without access to these essential tools, an individual franchisee cannot convince a mediator to exercise fair advice and persuasion. The franchisee is confronted with a franchisor with substantial bargaining superiority derived from each of the enumerated factors. There is no wonder that a group of major franchisors has combined to sponsor such mediation. They have been and will be joined by many others. And they can be depended upon to mount major public relation campaigns for such mediation as a means to avoid litigation. That argument is particularly attractive in legislatures.

The IFA will attempt to use the general attraction of mediation as a substitute for the proposed legislative confirmation of important procedural and substantive franchise rights. They simply avoid the obvious fact that when franchisees obtain legislative support, they can more realistically seek justice in mediation, arbitration or in court. Franchisees could still use private mediation services either independently or through the almost universal court provisions for access to such alternate dispute resolution without surrendering any of their procedural or substantive rights and at considerably less expense.

Intelligent legislators will not be deceived by the combination of a useless Code of Ethics without reliable procedures or penalties to enforce the standards, the invitation of franchisees to join the IFA without any assured access and right to determine policy and performance and mediation that would be helpless to guarantee access to due process.

---

(1) See (CCH) Bus. Franchise Guide ¶ 3000 and 4000.

(2) For the Iowa statute, see (CCH) Tr. Reg. Rep. ¶4150, et seq.; see also South Dakota House Bill No. 1256 introduced Jan. 27, 1993. There have been constitutional challenges of the expressed application of such laws to existing, as well as future, franchisees. See, e.g. *McDonald's Corp. v. Nelson*, 64 (BNA) ATRR 612, (S.D. Ia. 1993) (appeal pending). (Iowa statute offends federal and state constitutions in its application to existing franchisees.) There is disagreement between various circuit courts of appeal on the constitutionality of state legislation made applicable to all future as well as to existing franchisees. Some courts have held this to be a violation of the contract clause, but more progressive courts have held that such legislation should be evaluated as a restriction on conduct. Such statutes have been sustained if the state legislature clearly declares that the act represents "fundamental public policy" and its intention that the measure apply to existing as well as future franchisees. See, *Solman Distributors Inc. v. Brown-Forman Corp.*, (CCH) Bus. Franch. Guide ¶9487 (1st Cir. 1989).

(3) *Schoch v. Burger King Corp.*, 756 F.Supp. 543 (S.D. Fla. 1991); *Schoch v. Burger King Corp.* CCH Bus. Franch. Guide ¶10,049 (D.C. Fla. 1992) (rehearing).

(4) *Wright-Moore Corp. v. RICOH Corp.*, 808 F2d 122, (CCH) Bus. Franch. Guide ¶9665 (7th Cir 1990), after remand, 794 F.Supp. 844 (N.D. Ind. 1991), aff'd. ___. F2d ___ WL 322668 (7th Cir. 1992).

VIDEO DATA SERVICES®
The National Video Taping Service
30 Grove Street
Pittsford, NY 14534

Corporate Offices
(716) 385-4773

OUTLINE OF TESTIMONY OF STUART J. DIZAK
SMALL BUSINESS HEARING 4/21/93
FRANCHISING: IS SELF-REGULATION SUFFICIENT?

BACKGROUND OF STUART J. DIZAK AND VIDEO DATA SERVICES

Good Morning:

My name is Stuart Dizak, and I am President of Video Data Services, located in Rochester, New York. I come before you this morning with a unique perspective of being both a franchisor as well as previously a franchisee. I am accompanied by Robert Muller, one of our affiliates in the Washington DC area. Mr. Muller joined VDS 5 years ago and has since become one of our most successful affiliates. He has provided video production services for the United states Congress as well as well as the Official U.S. Parks Dept Video Tour of Arlington National Cemetery. Bob is also very knowledgeable of franchising from the franchisees point of view.

My personal experience with franchising began in 1980 when I purchased a video rental store franchise from "Video Connection of New York." Unfortunately, this turned out to be a very negative experience. As part of the sales pitch to convince me to buy into the franchise, the president of Video Connection personally informed me that on an initial investment of $25,000 I should be able to net a minimum of $50,000 the first year and $100,000 or more thereafter. I was furnished with the franchise disclosure documentation and had it reviewed by my attorney. He found it somewhat limited in information and wrote in a few changes. However, he could find nothing that would discourage my proceeding. So, I bought into the franchise.

When my grand opening day arrived, I had no exterior signs, only half of the initial merchandise that I had ordered, none of the grand opening promotional material, and none of the home office personnel were there to assist as was promised. This lack of support meant my business got off to a very poor start and within six months I decided to close the business down--incurring a loss of over $50,000. This was February of 1981. At this time I decided to move back to Rochester. I discussed taking legal action with my attorney but he advised me that the only damage I could sue for was the return of the initial franchise fee and even if I won, it would probably cost me more time and money than it would be worth.

Two years later, shortly after a public stock offering, Video Connection of New York went out of business. Video Connection was the pioneer of franchising video rental stores. If they had delivered on their promises, they would probably now be in the same

position as "Blockbuster Video."

There was some good that came out of this experience, however. While I had the video store open, I realized the potential of franchising and came up with the idea to franchise my own video production company.

Prior to my starting Video Data Services, I conducted a market survey of franchising. I began by contacting several successful franchisees in various fields to find out what they liked most and what they liked least about franchising and their relationship with the franchisor. They indicated that what they liked most was the franchisor's name. What they liked least, by far, was the royalty percentage they had to pay to the franchisor. They felt the growth of their business was due more to their own efforts than the franchisor and they disliked having to pay increasing dollar amounts to the franchisor as a result of their own efforts. The second biggest complaint was misleading information contained in the franchisor's recruitment literature and misrepresentations by the franchisor's sales representatives. They went on to say that they could not understand the disclosure documentation and that in most cases it was one sided. Some franchisees also complained about insufficient follow-up support from the franchisor.

I also spoke with several potential franchisees who decided against franchising. They indicated some of the complaints noted above, but also were not willing to leave the security of their current job without a new full-time business.

As a result of the above information, I decided that first and foremost in my business, I would provide support beyond the expectation of the franchisees. I would also have the franchise designed so that an individual could start on a part-time basis, and when the business was built-up sufficiently, convert to full-time. Instead of charging a royalty percentage of gross sales, I decided to simply charge a flat amount of only $500 per year. This might sound ridiculously low, but in the long term it did turn out to be a wise decision as it paid off in other ways. In fact, it is probably the number one reason for my firm's success. It is also why our affiliates (which is what we prefer to call them) probably rank among the highest in satisfaction in the franchise industry.

Before I proceed any further, I should mention that the flat-fee amount would not work for a large franchisor such as McDonald's. In addition, my entire presentation and experience is based on the smaller franchises, selling for under $100,000. This also appears to be where most of the abuses are occurring.

In return for this low fee of $500 per year, we ask our affiliates, once they are established, to assist the new affiliates coming after them with both marketing and technical support. Our affiliates also act as our sales force. We do not use outside sales representatives since we feel our existing affiliates have far more credibility and will not inflate expectations. In other words, they tell it like it is, both good and bad. It actually adds to our credibility if there are some negative comments.

Another reason for the success of our firm is that we promote communications among our affiliates. I have found that the majority of franchisors try to keep their franchisees in the dark and discourage communicating with each other. We do the opposite; for example a good portion of our monthly newsletter is put together by our affiliates and our annual convention is planned and organized by our affiliates who volunteer their time to do it.

Last month our company held its annual convention here in Washington, DC. We invited Robert L. Perry to be our guest. Mr. Perry is well-known in the franchise industry and is the author of the book, "The 50 Best Low Investment, High Profit Franchises." At the convention, Mr. Perry had the opportunity to speak with many of our affiliates, of his own chosing. After doing so, he asked if he could be allowed to make a brief presentation. In his speech, he stated that Video Data Services was the most open, welcoming team that he had ever seen in franchising. He went on to say that he had never seen a group work together as well as the Video Data Services franchise team. His final comment was that Video Data Services was the ideal that franchisors should aspire to be.

I would now like to express my point of view regarding both the proposed new disclosure documentation as well as self regulation by the franchising industry.

Franchising started out with a negative connotation. It was firms such as Holiday Inn, McDonald's, and Burger King who gave franchising the good name that it has had until recently. The changes that I feel are necessary to return franchising to respectability are:

1. Simplification of the language of franchise disclosures: Our firm's franchise disclosure documentation is relatively simple, yet we still have attorneys calling us to explain the various terminology. Furthermore, in examining other disclosures, it appears they are purposely written to be totally one-sided. They are also written so that they are almost impossible to decipher.

   If an attorney cannot decipher a disclosure documentation, then how is the average layman going to? Someone who is buying a six figure or higher franchise will normally have the business expertise as well as legal support for due diligence. However, an individual spending below this amount is, in most cases, investing his or her life savings and will not even contact an attorney. They have to go strictly by what they can interpret from a disclosure documentation.

   It is my belief that any new disclosure requirements should require the number of franchisees that have left, either willingly or unwillingly. Also, if the franchisor makes any earnings claims whatsoever, either verbally or in writing, these earnings claims should be substantiated in the disclosure documentation.

   The boldest print on the cover of all franchise disclosures should state, "Any earnings claim or any other statement made to you by the franchisor is meaningless unless it is backed-up in the disclosure documentation."

2. As far as self-regulation, I am not aware of any industry self regulating groups that can be an example for franchising. In fact, I have never seen any organization capable of self-regulating itself and I doubt that any individual here has. I consider myself a very fair individual, but if I am self-regulating, I am still going to look out for my own interests first.

A good example of how self-regulation cannot work:

The International Franchise Association has a large franchise show scheduled this weekend in Washington, DC.

The advertising claims on TV and in print claim the success rate in franchising is 94% and the average franchisee earns $124,000 per year. **This statement is preposterous!.** If this were true, one-third of the individuals that are present at this hearing would not be here, they would be out running their own franchises! In the last two weeks I have contacted over 20 franchisees of well-known franchisors in the western New York area such as Mailboxes, etc. and Subway shops. Their average earnings were approximately $36,000 per year. I strongly question the sources used for The Gallop poll that provided the above figures. The figure of $124,000 could only apply to a very limited number of extremely large franchise businesses. Also, if one watches the visual background proceeding the $124,000 figure, you will see on display the names and logos of the largest franchisors.

3. One of the biggest problems among the franchisees I surveyed was the unrealistic earnings claims made by their respective franchisors. This by far the most important factor that has to be addressed in any new regulations.

4. The total cost of our franchise package is $17,950, yet we still have prospects who feel that on this investment they should be able to earn at least $50,000 their first year. My own office as well as our affiliates go out of our way to explain to these individuals what their goal should be--and that is their first year's goal should only be to make back their initial investment. We also have in our computer what is called a "Sorry Letter". If we feel that for whatever reason an individual cannot make it in our business, we simply send him this letter indicating that he or she is not qualified. We are simply avoiding future problems for both parties.

5. The biggest obstacle to future growth, however, is not the economy, but the negative press that franchising is currently receiving. In order for franchising to turnaround, it is going to have to improve its image.

I would like to relate a recent conversation that I had with an advertising rep of a major business opportunity magazine

that we have advertised in over the last ten years.

I called to complain that even though their advertising rates have gone up considerably, the amount of leads we have received from advertising in their magazine have dropped in half over the last twelve months. I also told him that the end result was that we have received only 3 sales from their publication during the last 6 months vs. 8 sales during the same time period the previous year. I went on to tell him that our company would probably have failed if we had to count on advertising. What has kept our company going is the very favorable write-ups we have received in various magazines and books on franchising. Another reason is independent publications have a far greater credibility than a magazine advertisement. I also indicated to him that for the first time in our history our overall sales were down from the previous year.

His response to me was, "Stuart, you should be happy. Most of our business opportunity and franchise advertisers are indicating a 40%-50% decrease in sales from last year."

One can make several conclusions from that statement:

a. The economy

b. The negative image that the press is generating on franchises

c. The general public is becoming far more careful in investing in franchises and business opportunities.

I would rather doubt that the larger, established franchisors would take strong exception to Chairman LaFalce's proposed new disclosure regulations. **The reason he will get a lot of opposition from smaller franchisors is that if Chairman LaFalce's regulation goes into effect, within a few months, you will probably see 10%-20% of these franchisors ceasing to do business.** In the long-term, however, this will benefit franchising as a whole, as well as those franchisors who do run a legitimate business. Once again, franchising will take on the positive image that it previously had.

I will close my presentation by adding that if franchisors would look upon their franchisees as partners rather than someone simply to make money off of, in the long-term they would be far more successful. For franchising to succeed, both the franchisor and the franchisee must mutually benefit.

CONGRESS OF THE UNITED STATES

House of Representatives

Committee on Small Business

Hearing

"Franchising: Is Self-Regulation Sufficient?"

April 21, 1993

Written testimony of

W. Michaael Garner
Schnader, Harrison, Segal & Lewis
330 Madison Avenue
New York, New York 10017
(212) 973-8022

1144-G-2587
04/19/93: 20:28

Mr. Chairman, members of the Committee, fellow witnesses and guests, I want to thank you all for this opportunity to present some views concerning questions of self-regulation in franchising today. Last week, at the time I was requested to appear before you, I was in the midst of a trial that did not conclude until Friday. Because of the limited amount of time available to prepare these remarks, I have been unable to document my comments to the extent that I would like. I will attempt to follow the Chairman's questions throughout.

Actions and Changes Needed In Franchising to Address Problems & Abuses In Representation and Sale of Franchises and In Conduct of Ongoing Franchise Relationships

Let me being by identifying what I perceive to be some of the recurring problems in the franchise relationship.

First, misrepresentation and abuse in the sale of franchises continues to occur both in new franchise companies as well as in established franchisors. These problems are compounded by the absence of effective remedies for franchisees and the unwillingness of franchisors to respond to franchisee problems. Let me give you three quite different examples.

In the case I tried last week, (for which there is not yet a verdict) my clients claimed that Hardee's Food Systems, the nation's third largest hamburger chain, had provided them with unsubstantiated earnings claims for a specific site and had made false representations that the plaintiffs could become multiple store operators rapidly through the purchase of company owned stores. The evidence in the case demonstrated that while

Hardee's had a policy of compliance with the FTC Rule and state laws governing franchise sales, the area vice president testified that he had no mechanisms to enforce compliance with Hardee's policies or with law. After the franchisees had invested almost $1 million, they discovered that no company owned stores were for sale, and that the sales estimate was overstated by some $200,000. They attempted repeatedly to work out a business solution to the problem. Hardee's refused to recognize that its violation of law or plaintiff's injury and for all practical purposes, refused to discuss the matter.

At trial, Hardee's quite candidly admitted that it had made an unlawful earnings claim, but successfully convinced the judge that under both Indiana and Federal law, there was no private remedy. My clients were then left with proving what amounted to a common law fraud case, which is far more difficult to prove.

I want to stress that my client was a lawyer of over twenty-five years experience -- and is renowned for his ability to mediate disputes and to find practical business solutions to difficult legal problems. The franchisor, however, was unwilling to discuss settling the matter in any meaningful way.

A second example, concerns the Reids, Florida franchisees of All Tune & Lube. Believing that the franchisor had misled them, they presented their grievances to the International Franchise Association. IFA assured them that it would keep their information confidential; would conduct a private investigation;

and above all, would not turn over their documentation to the franchisor. Shortly thereafter, they learned that IFA had turned the information over to its counsel, which in turn was counsel to the franchisor. There was both a breach of promise and a conflict of interest. Subsequently, the IFA informed the Reids that its board of directors might consider their complaint. But when they tried to find out if it had, no one at IFA responded to their letters or was able to give them a status report.

The third example concerns Mr. Sign Franchising Corp., which built its system on false representations contained in its offering circular, then collapsed when it was unable to deliver on its promises, leaving over 70 franchisees empty handed across the country. Numerous franchisees complained to state regulators in New York and other states and to the FTC. No action has been taken.

These examples illustrate vividly (1) the failure of an individual franchisor, Hardee's, to self-regulate even when presented with indisputable evidence of its own wrongdoing and a clear opportunity to do so; (2) the failure of industry regulation by the IFA; and (3) the failure of federal and state regulation.

The redress franchisees have today is through private lawsuits. Most franchisees cannot afford a private lawsuit. Lawyers are reluctant to take these cases on a contingency basis because the cost and burden of discovery can easily outweigh the likely contingent recovery. Moreover, since these are heavy

document and deposition cases, and usually involve travel, there are potentially thousands of dollars of up-front expenses. For the franchisee willing and able to pay hourly rates, the cost of a private lawsuit, through trial, begins in six figures.

A second arena of problems involves ongoing support and assistance to the franchisee. A major franchisor in the automotive repair business today faces numerous lawsuits from unhappy franchisees. Although the charges include false earning claims and poor site selection, the overwhelming complaint is the franchisor's failure to visit with and to support franchisees in their ongoing operations. The result: franchisees have been unable to maintain a competitive edge or resolve simple problems. In another example, a Fortune 500 company attempted to enter franchising by staffing-up quickly with executives and managers hired from a variety of existing franchisors. The effort was disastrous. The franchisor eventually had to turn its training and on-going support functions over to one of its franchisees, who in fact had far more experience and expertise in the field than the franchisor. These examples point to the need for some type of remedy for a franchisor's unwillingness or inability to perform its obligations in a competent or workmanlike manner. In short, a duty of competence is needed.

A third problem I see concerns the allocation of the burden of meeting competitive conditions in the marketplace. Franchisors, for example, want their franchisees to bear the burden or upgrading facilities from time to time; the upgrade may

be modest or it may be major, requiring the franchisee to re-locate or rebuild its facility. A second example would be new products, which the franchisor requires the franchisee to introduce, but which sometimes fail. Who bears -- or should bear -- the losses arising from a new product failure? A third example is encroachment, or the franchisor's invasion of the franchisee's geographical territory or product line.

This type of problem is quire different in nature from franchisor fraud or the failure to deliver goods or services in several respects. First, it tends to be system-wide as opposed to individual, and hence franchisees may be able to harness their collective efforts to address the problem. Second, in many cases the problem is prospective and can be addressed in advance, before the harm is done, rather than retrospective, after the harm is done. Third, while there is clearly a financial burden associated with these changes, it is usually not a life-threatening loss and may in the long run benefit both parties to the relationship. At least in the cases where the issue is system-wide and prospective -- e.g., the franchisor wants all franchisees to put in drive-thrus at their expense -- there is an opportunity for collective action by franchisees.

Although my evidence is far from scientific, and is at best, anecdotal, I do not think that we are seeing the types of problems with franchisee terminations that we saw some years ago. Most franchise agreement contain provisions requiring good cause for termination, and most franchisors follow these requirements.

1144-G-2587
04/19/93: 20:28

The question, however, was what changes should take place in franchising to address these problems. I want to note, at the outset, that I know of many franchisors that practice the utmost good faith in their dealings with franchisees and prospective franchisees, and are quick to resolve disputes and slow to pull the trigger. These franchisors view their systems as parts of themselves and recognize their own self-interest in the welfare of their franchisees.

In systems where there are problems, typically what I have found is denial of any responsibility for a franchisee's complaint. A franchisee is a store number and a revenue stream, not a small business staffed by human beings. Where there is evidence of the franchisor's fault, the franchisor reacts by paying legal fees for defense -- where it knows that it can outspend and usually out-lawyer the franchisee.

The changes that must take place, in my view, are changes in attitude. We cannot expect any type of self-regulation to work unless franchisors are committed to it.

Can Self-Regulation Provide a Response to These Problems?

At the outset, I would like to say that I encourage all franchisors to attempt self-regulation. Internal ombudsmen programs, review panels, and alternative dispute resolution in certain areas can go a long way toward resolving disputes,

67-397 O - 94 - 4

particularly early in the process. However, self-regulation at this time does not seem to be an appropriate response to problems facing franchising for the following reasons:

> Self-regulation will, by definition, be confined to individual companies, or companies that are members of a group such as the International Franchise Association. Many of the problems I have seen involve companies that are not members of the IFA; hence, they would not be subject to any regulatory efforts by that body.
>
> In franchising, there is inherent tension between the interests of franchisors and franchisees that we must recognize is in many respects intractable. For example, the franchisor looks to the franchisee for the investment of capital to build a unit, but has an interest only in the income stream from royalties once that unit is completed. Likewise, the franchisor looks at the franchise relationship as a contract limited to a term of years whereas the franchisee looks at the business as a life-long commitment. It is difficult to imagine a self-regulatory scheme that would not be biased in one direction or the other.
>
> There are serious questions in my mind as to whether the sanctions available through self-regulation would be sufficient to redress the grievances of franchisees. Expulsion from an industry group, for example, would do little to satisfy a franchisee who has lost substantial amounts of money.
>
> There are serious questions as to whether procedures for self-regulation would provide franchisees with the benefits and protections that they receive under state and federal procedural rules of litigation. For example, in order to prove fraud, the franchisee may need to conduct extensive discovery of the franchisor's files in order to prove intent. Typically in arbitration, for example, discovery is not available and therefore the franchisee may be unable to obtain such documentation.

-- Franchising is extremely diverse, and I question whether there is any single scheme that will be appropriate for all systems. For example, some systems require a sunk investment of several million dollars; others require only a few hundred dollars, with no sunk investment. Some franchisors have predominantly multiple-unit developers, who tend to be savvy business operators; others have primarily mom-and-pop operations.

For these reasons, I do not think self-regulation can play a major role in resolving the problems franchising faces today. I believe federal legislation is necessary. Self-regulation is an idea that is basically new to franchising, and it should be an arena for experimentation and gaining of experience by franchisees. I can see it playing an important role as an "early-warning" system under which a franchisee could complain to a franchisor at an early stage of a potential dispute and the parties could attempt to mediate some resolution. If the mediation were unsuccessful, the franchisee could proceed to court.

I am not sufficiently familiar with comparable examples of industry self-regulation to discuss them.

Structure of Self-Regulation

Since I am not a categorical advocate of self-regulation, I do not have strong views on how it should be structured, who the authority should be or how it should be enforced.

1144-G-2587
04/19/93: 20:28

To the extent that there is any self-regulation, I think a key should be both the actual and perceived independence of the regulatory authority. This could be accomplished, for example, through panels of mediators that included both franchisor and franchisee representatives. Second, any self-regulatory scheme must be accessible to franchisees. Perhaps the greatest difficulty that franchisees face is the high cost of litigation. Because self-regulation by its nature contemplates yet another step in the resolution of a dispute, it must be sufficiently inexpensive so that the franchisee may pursue it without further encumbering what are usually meager assets. The question of who should the governing or regulating authority is particularly difficult. There is no single independent body to which franchisors must belong; while the IFA represents many franchisors, it certainly does not represent all. Finally, enforcement presents a real problem. Unlike the National Association of Securities Dealers, expulsion from a franchise trade association carries no real sanction; I would recommend that under any scheme of self-regulation that the aggrieved party have the alternative right to seek redress in the courts.

Alternatives To Self-Regulation

In my view, the answer to the problems that franchising faces today and will face over the next decade lie not in self-regulation but in uniform federal regulation with respect to both disclosure and the franchise relationship. One of the great

ironies of the present scheme of regulation is that franchisees that receive erroneous information through the disclosure process have no private right of action under the FTC Rule. Unless they can avail themselves of a state statute that provides them with private remedies, they are relegated to common law fraud claims, which usually require a very high burden of proof and which also require that the franchisee prove that the franchisor intended to defraud it -- an almost impossible task in the absence of a real smoking gun.

I think a duty of competence is appropriate, but only at a relatively low level unless the franchisor holds itself out otherwise. I question whether we need legislation addressing system-wide changes for competitive or economic reasons. Even though I do not see the problems with termination that there have been in the past, I believe a national standard will go a long way toward ensuring uniformity in resolving franchise disputes.

Thank you.

International Franchise Association

***The Voice of Franchising*™**

STATEMENT OF THE
INTERNATIONAL FRANCHISE ASSOCIATION
ON
SELF-REGULATION BY THE FRANCHISE INDUSTRY
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

PRESENTED BY
GIL THURM
SENIOR VICE PRESIDENT & CHIEF COUNSEL
INTERNATIONAL FRANCHISE ASSOCIATION

APRIL 21, 1993
WASHINGTON, D.C.

1350 New York Avenue, N.W. • Suite 900 • Washington, D.C. 20005-4709 • 202/628-8000

Mr. Chairman, Members of the Committee, I am Gil Thurm and I am the Senior Vice President & Chief Counsel of the International Franchise Association (IFA).

IFA Chairman Stephen Lynn has asked me to thank you for inviting him to testify, and he appreciates your understanding of his unavoidable scheduling conflict which prevented him from appearing here today. He looks forward to an opportunity to meet with you, Mr. Chairman, and to appear before your Committee at a later time. I appreciate this opportunity to appear here today on behalf of IFA.

The International Franchise Association is a trade association which serves as the voice of franchising. IFA is a resource center for both current and prospective franchisors and franchisees, as well as for the government and the media.

Mr. Lynn, who is Chairman of the Board and CEO of Sonic Corporation, recently stated that his goal as IFA Chairman is to make this a year of building bridges. Mr. Lynn stated: "I have witnessed first-hand that cooperation, consensus and compromise are key components of a successful organization. And it is my wish to begin to build a bridge between the franchisor community and our customers, the franchisees. Cooperation between these two groups is not a sweet sentiment...it is an economic necessity to the future of franchising."

The nation's franchised businesses account for over one-third of all retail sales -- $758 billion, and employ more than 7 million people. While other sectors of the American economy have been shrinking in recent years, franchising has been expanding, creating more than 18,500 new businesses last year, which added more than 100,000 new jobs to the economy. We must seek ways to stimulate the growth of franchising, not stifle it.

Chairman Lynn also stated, as a part of his remarks at IFA's 33rd Annual International Convention, on February 8, 1993:

"The theme of my chairmanship is GROWTH THROUGH UNITY. Franchisee and franchisor...working together.

-- Working together for success.
-- Working together to find better ways to bring high quality products and services to the marketplace.
-- Working together to head off potentially harmful influences such as outside regulation and legislation.
-- And working together to protect the future of franchising and to lay the groundwork for franchising to play an important role in our economic growth well into the next century."

FRANCHISEE ADVISORY COUNCIL

To achieve this desirable result, IFA began by creating more meaningful dialogue between franchisees and franchisors. To this

end, the IFA Board of Directors has voted to create a Franchisee Advisory Council. This Council has three goals:

1. To promote the concept of franchising as a mutually beneficial relationship between franchisees and franchisors within the IFA;

2. To seek constructive ways to solve disputes between franchisees and franchisors; and

3. To explore ways to increase the participation of franchisees within the IFA.

The Franchisee Advisory Council is only a first step. Our next step is a move toward self-regulation.

CODE OF ETHICS

In that regard, IFA has established a Franchise Code of Ethics which sets standards of conduct for franchisors in dealings between franchisees and franchisors.

The Franchisee Advisory Council has been asked to help us determine how this Code will be enforced throughout our membership.

We realize, however, that just setting the rules will not prevent conflict. As Mr. Lynn pointed out at our recent convention, "In fact, the interdependent nature of franchising is fraught with the potential for conflict. So another critical objective for the coming year will be to seek out ways of setting conflict to rest -- without resorting to litigation or

legislation."

ALTERNATIVE DISPUTE RESOLUTION

Accordingly, IFA and member companies have taken steps to provide the leadership and guidance for Alternative Dispute Resolution. We believe that a well-considered Dispute Resolution Program will serve -- not only to resolve conflicts in the early stages -- but also to foster an environment which will strengthen the franchise relationship. Building a spirit of cooperation and compromise is critical to the future of franchising.

In this regard, the Center for Public Resources (CPR) announced on February 8, 1993 that a group of major franchise companies have joined to create an alternative dispute resolution (ADR) process to offer to all franchisees and franchisors as a mediation vehicle to settle franchise disputes. Called the National Franchise Mediation Program, this ADR process has been designed to resolve disputes between franchisees and franchisors quickly and cost-effectively through the CPR Legal Program.

The Center for Public Resources' CPR Legal Program is a not-for-profit alliance of 530 major corporations, leading law firms, prominent legal academicians and public institutions. Through the CPR Panels of Distinguished Neutrals, business and public disputes involving more than $5 billion were successfully resolved through ADR in the three-year period ending December 1992.

The founding members of the National Franchise Mediation program include: Burger King Corporation, Dunkin' Donuts, Hardee's, Holiday Inn Worldwide, Jiffy Lube, McDonald's, Pizza Hut, Southland and Wendy's. Additional companies, Kentucky Fried Chicken and Taco Bell, have also committed to the process.

CPR President James F. Henry said the ADR mediation process "offers a less time consuming, less expensive, less antagonistic route to settle disputes than traditional court proceedings, with the opportunity to agree on solutions courts could not order. ADR will help franchisors and franchisees preserve relationships and productivity, since both parties must be satisfied with terms of the settlement to their disputes."

"With the National Franchise Mediation Program, franchisees and franchisors will be able to resolve disputes with the assistance of a qualified mediator nominated by CPR from a newly organized franchise panel of neutrals," said Henry.

All founding group members have committed to participate for the next two years in a mediated dispute resolution process for any dispute with one of their franchisees not resolved through internal negotiations. A mediator located in the franchisee's region will be jointly selected by the franchisee and franchisor involved in the dispute. Costs will be jointly shared by both parties to the dispute.

Henry noted that the National Franchise Mediation Program will be a voluntary and informal process. "A mediator has no power to impose a solution on the parties," he said. "Rather, mediators will assist parties in negotiating solutions that meet their interests and objectives."

Mediation can generally be concluded rapidly, at moderate cost. In this program, a time limit will be set, after which the parties are free to pursue other remedies, unless both agree to the contrary. If mediation fails, other options are not foreclosed.

CONCLUSION

Mr. Chairman, we believe that the various programs and initiatives described above are very important and positive first steps toward self-regulation in the franchising industry. As Steve Lynn stated in accepting the role as IFA Chairman, "My promise is that 1993 will be known as the year of inclusion...the year in which franchisees are recognized as a meaningful part of the IFA...a year in which we celebrate the mutually beneficial aspect of our relationship...a year when franchisees and franchisors unite."

Mr. Chairman, the International Franchise Association appreciates this opportunity to present its views, and we look forward to continuing to work closely with you and the Members of this Committee.

We would be pleased to respond to any questions the Committee may have.

Thank you.

May 17, 1993

The Honorable John J. LaFalce
Chairman
House Small Business Committee
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for the opportunity to appear at your Committee's hearing on April 21, 1993, to discuss the subject of self-regulation in the franchise industries. This letter will provide the information for the record as requested and discussed during that hearing.

GALLUP STUDY

As I stated in answer to the question involving the International Franchise Expo, and advertisements related to the Expo, attached is the Executive Summary of the Gallup Study for the record. That Expo, and the advertisements related to it, were all produced by an independent contractor under a license agreement with the International Franchise Association, without further involvement by IFA or by any of the other 17 co-sponsoring Associations of the Expo.

MINORITY BUSINESS DEVELOPMENT

In response to the Committee's question about minority business development and related issues, I am pleased to submit to the Committee a recent article from Franchising World which details the "preliminary results of a recent survey by IFA's Minorities and Women in Franchising Committee. Of the more than 180 respondents, 41 percent reported targeting recruitment efforts to minority franchisees; 54 percent use minority suppliers, vendors and media, and 29 percent offer direct financial assistance to new minority franchisees."

Also in connection with the specific question from Mr. Mfume, for which I promised a further response, I submit the following supplemental information for the record. Our society has determined that discrimination in business practices is not to be tolerated. The Association's Code of Ethics, a copy of which is attached to this letter, clearly reflects that discrimination, whatever the basis, is not to be tolerated. You will note in the Code of Ethics, in the preamble, that "franchising

World Headquarters: 1350 New York Avenue, N.W. • Suite 900 • Washington, D.C. 20005-4709
Telephone: 202/628-8000 • Telefax: 202/628-0812

must reflect the highest standards of ethical business practices." In Section II: Principles "Franchisors shall conduct their business professionally, with truth, accuracy, fairness, and responsibility." Later, in the same section "Franchisors shall offer equal opportunities in franchising for minorities, women and the disabled." Finally, in Section IV: Standards of Conduct "A franchisor shall not discriminate in the operations of its franchise system on the basis of race, color, religion, national origin, age, disability or sex."

It is important to note and acknowledge that many of the most progressive franchisors have created programs designed to recognize the special needs of minority franchisees and suppliers. These affirmative action programs need to be recognized as legitimate efforts to rectify those individuals who have historically or economically been discriminated against.

SELF-REGULATION

As I indicated in answer to questions regarding the Association's Code of Ethics and some of the stories told by another witness, there are two sides to those stories. For example, let us look at the situation referred to during the hearing where a franchisee submitted a complaint to the IFA. In that situation, following IFA's regular practice, the franchisee was told that if he or she would like to submit a complaint and any other material to us, IFA would forward that complaint and material directly to the franchisor. The franchisee chose to provide such information to IFA and as had been previously explained to the franchisee, IFA sent that material to the franchisor. Franchisor lawyers would be pleased to respond further to the other stories described by the franchisee attorneys who were invited to testify at the hearing.

In response to the Committee's questions regarding enforcement of the Code of Ethics, it should be recognized that trade associations by their nature are voluntary. We are not quasi-judicial branches of government and thus the harshest form of penalty that we may inflict is to ostracize those who engage in unethical behavior. It should also be noted that there are a range of actions which are available to a voluntary organization such as a trade

association, and that range of actions may not be too dissimilar from the range of actions available to the Committee on Standards of Official Conduct of the U.S. House.

The Committee may also be interested in a recent "Wall Street Journal" article on our efforts to promote self-regulation, and that article is also attached for the record.

Mr. Chairman, I appreciate the opportunity to present this supplemental information for the record of the April 21 hearing, and I look forward to continuing to work with you and your Committee on these matters.

Sincerely,

Gil Thurm
Senior Vice President
& Chief Counsel

Attachments:
- Executive Summary of Gallup Study
- Minority Business Development Article
- Code of Ethics
- "Wall Street Journal" Article

The Gallup Organization, Inc.

PRINCETON, NEW JERSEY

INTERNATIONAL FRANCHISE ASSOCIATION
Washington, D.C.

NATIONAL FRANCHISE OWNER STUDY

Executive Summary

January 1992

Prepared by
The Gallup Organization, Inc.
Princeton, New Jersey

Introduction:

The Gallup Organization, Inc. of Princeton, New Jersey conducted market research for the International Franchise Association (IFA) of Washington, D.C. The overall purpose of this market research was to determine, among franchise owners, their attitudes and opinions with regard to their franchise-owning experience.

Methodology:

To accomplish the objectives of this study, Gallup interviewed, by telephone, a national sample of 994 franchise owners across the continental United States during November and December 1991.

Stability of Results:

At the 95% level of confidence, the maximum expected error range for a sample of 994 respondents is ±3.1%. Stated more simply, if 100 different samples of 994 individuals who were franchise owners in the United States were chosen randomly from a national sample of franchise owners, 95 times out of 100 the results obtained would vary no more than ±3.1 percentage points from the results that would be obtained if the entire franchise owner population were interviewed.

National Franchise Owner Study

Major Findings:

1. Almost all (94%) of the respondents said that overall, they considered their franchise operation to be either very (47%) or somewhat (47%) successful.

2. More than seven-tenths of the franchise owners said that their franchise operation had either exceeded or met their expectations with regard to both their personal satisfaction in operating the franchise (76%) and their overall satisfaction (73%).

3. The respondents' high ratings of satisfaction and success of their operation did not come without hard work. More than eight-tenths of the owners said their franchise operation had met most of, or exceeded, their expectations with regard to the number of hours they had to work (they had to work more). In fact, a positive correlation existed between the respondents' overall satisfaction with the franchise and their levels of active involvement. The higher the respondents' level of active involvement on a day-to-day basis with the franchise, the higher their level of satisfaction.

4. Three-fourths (75%) of the respondents said that if given the same opportunity (knowing what they know now) they would purchase or invest in this same franchise business again. Respondents who had income of $50,000 or more were particularly likely to make such a re-investment (81%). Although respondents with higher incomes tended to be more likely to re-invest in the same franchise (if given the same opportunity), it should be noted that the majority of all respondent groups said they would repeat the investment in the franchise again if given the chance.

5. More than six-tenths (63%) of the owners said they were more satisfied with their franchise than with previous business experiences, while 23% reported the same level of satisfaction.

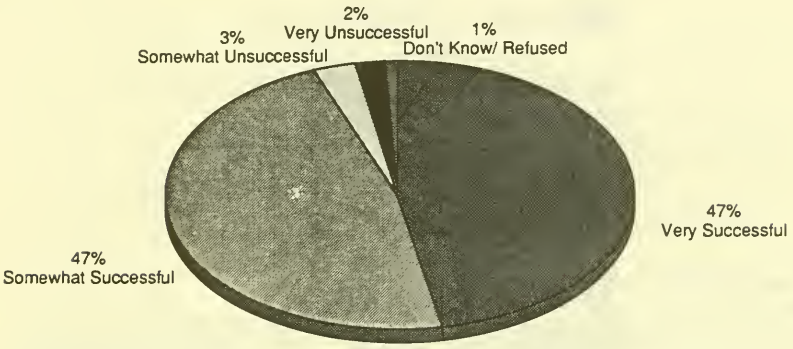
6. Almost eight-tenths (79%) of the respondents rated their relationship with their franchise or company as being either excellent (39%) or good (40%). Only 6% reported "poor" working relationships.

Table A
Sample Characterisitcs
(n=994)

Gender	
Male	82%
Female	18%
IFA Membership	
Member	71%
Nonmember	29%
Ownership of Franchise Operation	
Sole Owners	63%
Multiple Owners	36%
Years in Business	
Mean	7.4 yrs.
Median	5.0 yrs.
Estimated Gross Income Before Taxes	
Mean	$124,290.

Overall Success

"Overall, would you consider your franchise operation to be very successful, somewhat successful, somewhat unsuccessful or very unsuccessful?"
(n=994)



- Almost all (94%) of the respondents said that overall, they considered their franchise operation to be either very (47%) or somewhat (47%) successful. Only one in fifty (2%) said they considered their franchise operation to be very unsuccessful..
- Those respondents who tended to rate their franchise operation overall as being more successful included:
  - respondents with incomes of $150,000 or more (67%)
  - respondents who had been in business for 11 years or more (57%)

Table B

Estimated Annual Gross Income Before Taxes
(n=994)

Response	% Total
Less than $50,000	26%
$50,000 to less than $100,000	23%
$100,000 to less than $300,000	26%
$300,000 or more	11%
Don't Know	2%
Refused	12%

- On average, respondents reported their annual gross income, before taxes, as a franchise owner was $124,290. Approximately one-half of the respondents (48%) reported a gross income under $100,000, while slightly more than one-third (36%) grossed over $100,000.

Table C

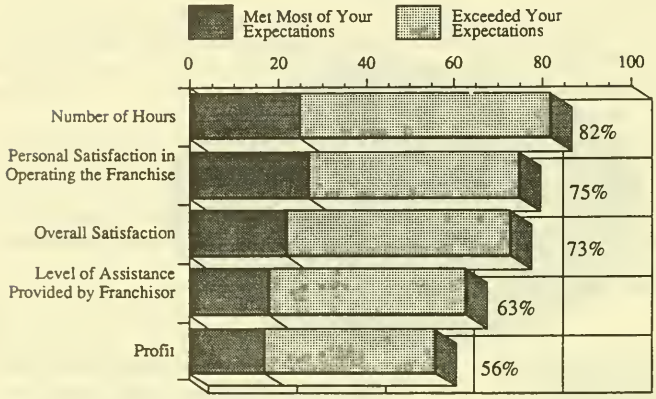
Estimated Total Investment Cost
Including Franchise Fees and any Additional Expenses
(n=994)

Response	%Total
$50,000 or less	37%
$50,001 to $100,000	19%
$100,001 to $300,000	15%
$300,001 or more	11%
Don't Know	4%
Refused	14%
Mean Cost	**$147,570**

- As would be expected, respondents reported a wide variety of amounts of total investment cost that they incurred for their franchise. On average, however, respondents reported investing $147,570.

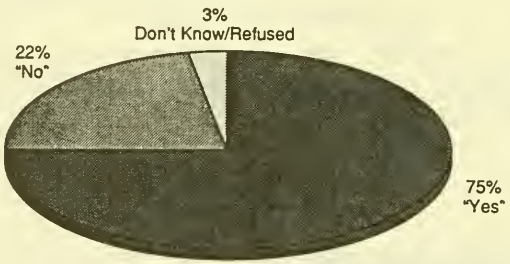
Expectations

Level of Expectations Being Met for Various Aspects of the Franchise



Given Another Chance...

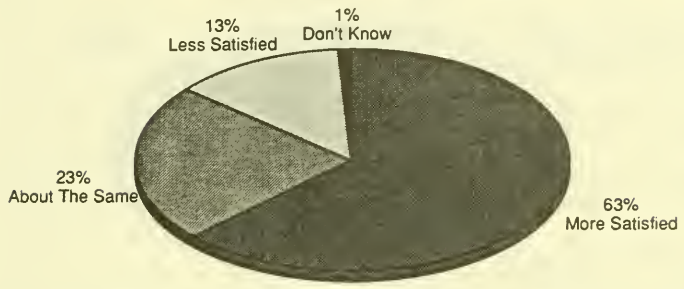
"Knowing what you know now, if given the opportunity, would you purchase or invest in this same franchise business again?"
(n=994)



- Those respondents who tended to be most likely to repeat their franchise investment included:
  - respondents with annual gross incomes of $50,000 or more (81%)
  - respondents who own two or more franchises (79%)
  - respondents who had been in the business five years or less (77%)

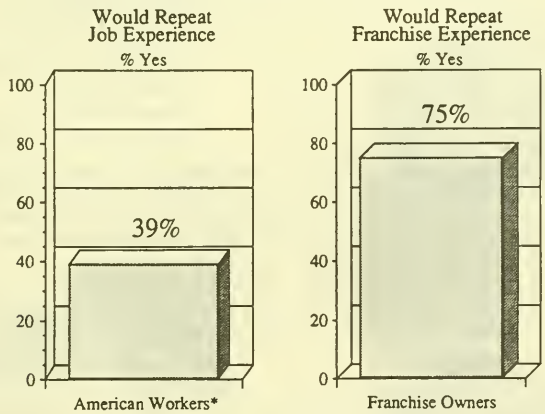
Comparison to Other Businesses/Jobs

Level of Overall Satisfaction as an Owner of a Franchise
Compared to Other Businesses Owned/Operated or Jobs Held
(n=994)



- Relative to other businesses they have owned or operated, or other jobs they have held, a majority of respondents (63%) reported they were more satisfied with the franchise operation. Only slightly more than one-tenth (13%) of the respondents said that previous businesses they had owned or operated or jobs they had held proved to be more satisfying than their current position of owning a franchise.

American Workers/Franchise Owners

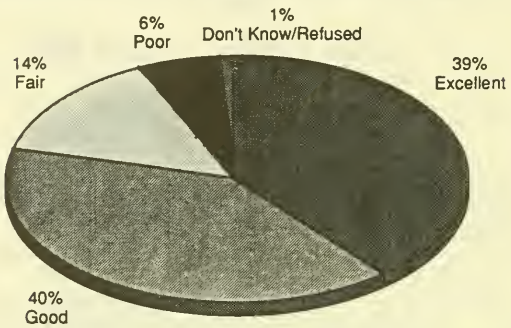


* Results are based on a national Gallup poll of n=783 Americans, 18 and older, who held jobs, conducted in July, 1991, with a plus/minus 4% error range.

INTERNATIONAL FRANCHISE ASSOCIATION

Relationship With Franchisor

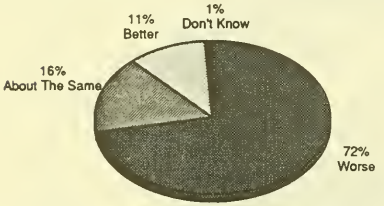
Ratings of Working Relationships with Franchisor Company
(n=994)



- Approximately four-fifths (79%) of the respondents rated their relationship with the franchisor company as being either excellent (39%) or good (40%). Only 6% of the respondents rated this relationship as poor.

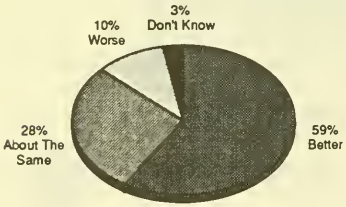
Rating of Economic Conditions

"As a business owner, compared to three years ago, do you think general economic conditions are better, about the same or worse?"
(n=994; % Total)



Looking Ahead

"As a business owner, in the next three years, do you think general economic conditions will be better, about the same or worse?"
(n=994)



For More Information

MPR Department
International Franchise Association
1350 New York Avenue, N.W.
Suite 900
Washington, D.C. 20005-4709
Phone: 202-628-8000
Fax: 202-628-0812

The International Franchise Association, founded in 1960, is the oldest and largest association representing franchisors in the world. IFA serves as a resource center for both current and prospective franchisors and franchisees, as well as government and the media.

NATIONAL FRANCHISING ★★WEEK★★
APRIL 18-25, 1993

INTERNATIONAL FRANCHISE ASSOCIATION

CODE OF ETHICS

SECTION I: PREAMBLE

Franchising is a business relationship utilized in more than 65 different industries. A wide variety of franchise relationships exist between thousands of franchisors and hundreds of thousands of franchisees. Business format franchising offers the best opportunity for individuals who are seeking to enter into business for themselves by providing a framework for a mutually beneficial business relationship.

In recognition of the increasing role of franchising in the marketplace, and the very beneficial and positive contributions of franchising to the American economy, the members of the International Franchise Association believe that franchising must reflect the highest standards of ethical business practices. This can best be achieved by means of a strong and effective *Code of Ethics*.

To protect and to promote the interests of consumers, franchisees, and franchisors, and to ensure that this unique form of entrepreneurship continues to flourish with a high degree of success and security, we, the members of the International Franchise Association (IFA), do hereby set forth the following principles and standards of conduct.

SECTION II: PRINCIPLES

Franchisors shall conduct their business professionally, with truth, accuracy, fairness, and responsibility.

Franchisors shall use ethical business practices in dealings with franchisees, consumers, and government agencies.

Franchisors shall comply with all applicable laws and regulations in all business operations.

Franchisors shall offer equal opportunities in franchising for minorities, women, and the disabled.

SECTION III: COMPLIANCE AND ENFORCEMENT

1. Applicability. The *Code of Ethics* shall be applicable to all IFA members in their United States operations.

2. Compliance. The policies and practices of members shall be consistent with the *Code of Ethics*.

3. Enforcement. IFA shall investigate complaints concerning possible violations of the *Code of Ethics* and, if appropriate, shall suspend, terminate, or take other appropriate action with respect to a member which is found to be in violation of the *Code of Ethics*.

SECTION IV: STANDARDS OF CONDUCT

1. Franchise Sales and Disclosure. In the advertisement and grants of franchises, a franchisor shall comply with all applicable laws and regulations. Offering circulars shall be complete, accurate, and not misleading.

All matters material to the granting of a franchise shall be contained in or referred to in one or more written documents, which shall clearly set forth the terms of the relationship and the respective rights and obligations of the parties. Such documents shall be provided to a prospective franchisee on a timely basis as required by law.

A franchisor shall encourage prospective franchisees to seek legal or other professional advice prior to the signing of a franchise agreement.

A franchisor shall encourage prospective franchisees to contact existing franchisees to gain a better understanding of the requirements and benefits of the business.

2. Good Faith Dealings. Franchisors and franchisees shall deal with each other fairly and in good faith, which means dealing honestly, ethically, and with mutual respect, in accordance with the terms of their franchise agreements. "Good faith dealing" is not intended to modify the terms of franchise agreements.

3. Franchisee Advisory Councils and Franchisee Associations. A franchisor shall foster open dialogue with franchisees through franchisee advisory councils and other communication mechanisms.

A franchisor shall not prohibit a franchisee from forming, joining, or participating in any franchisee association.

4. Termination of Franchise Agreements. A franchisor shall apply the following standards in connection with the termination of franchise agreements:

(a) A franchise agreement may only be terminated for good cause, which includes the failure of a franchisee to comply with any lawful requirement of the franchise agreement.

(b) A franchisee shall be given notice and a reasonable opportunity to cure breaches of the franchise agreement, which need not be more than 30 days.

(c) A franchise agreement may be terminated immediately, without prior notice or opportunity to cure, in the event of a franchisee's insolvency, abandonment of the franchised business, criminal misconduct or endangerment of public health or safety.

(d) The franchise agreement may be terminated pursuant to an express provision in the franchise agreement providing for a reciprocal right to terminate the agreement without cause.

5. Expiration of Franchise Agreements. A franchisor shall apply the following standards in connection with the expiration of franchise agreements:

(a) A franchisee shall be given notice at least 180 days prior to expiration of a franchisor's intention not to grant a new franchise agreement to the franchisee.

(b) The franchisor may determine not to grant a new franchise agreement:

(1) for good cause, which includes the failure of the franchisee to comply with any lawful requirement of the franchise agreement; or

(2) if the franchisor permits the franchisee to:

(i) during the 180 days prior to the expiration of the franchise, sell the business to a purchaser meeting the then-current qualifications and requirements specified by the franchisor; or

(ii) continue to operate the business under a different trade identity at the same location or within the same trade area.

(c) The franchisor may determine not to grant a new franchise agreement to a franchisee, without prior notice, in the event of the franchisee's insolvency, abandonment of the franchise business, criminal misconduct or endangerment of public health or safety.

(d) The franchisor may exercise any existing right to purchase the franchisee's business as provided in the franchise agreement.

(e) The franchisor may determine not to grant a new franchise agreement to a franchisee if the franchisor is withdrawing from the market.

6. Transfer of Franchise. A franchisor shall not withhold approval of a proposed transfer of a franchise when the following criteria are met:

(a) The transferring franchisee is in compliance with the terms of the franchise agreement;

(b) The proposed transferee meets the then-current qualifications of the franchisor;

(c) The terms of the transfer meet the then-current requirements of the franchisor and the transfer provisions of the franchise agreement;

(d) The franchisor determines not to exercise a right of first refusal in accordance with the franchise agreement.

7. Encroachment. In determining whether to open, or to authorize the opening of, an outlet in proximity to an existing franchised outlet, that will offer products or services similar to those of the existing outlet, a franchisor shall take into account the following:

(a) Territorial rights of the existing franchisee contained in the franchise agreement.

(b) The similarity of the new outlet and the existing outlet in terms of products and services to be offered.

(c) Whether the new outlet and the existing outlet will sell products or services to the same customers for the same occasion.

(d) The competitive activities in the market.

(e) The characteristics of the market.

(f) The ability of the existing outlet to adequately supply anticipated demand.

(g) The positive or negative effect of the new outlet on the existing outlet.

(h) The quality of operations and physical condition of the existing outlet.

(i) Compliance by the franchisee of the existing outlet with the franchise agreement.

(j) The experience of the franchisor in similar circumstances.

(k) The benefit or detriment to the franchise system as a whole in opening the new outlet.

(l) Relevant information submitted by existing franchisees and the prospective franchisee.

8. Alternative Supply Sources. A franchisor may offer a turnkey business. A franchisor may require that franchisees purchase products and services which utilize or embody the franchisor's trade secrets or proprietary processes or ingredients, or for which it is not practical to issue specifications or standards, from the franchisor or a supplier selected exclusively by the franchisor. A franchisor will permit franchisees to obtain other equipment, fixtures, supplies, and services from sources chosen by the franchisee, provided that the chosen suppliers demonstrate to the franchisor's reasonable satisfaction:

(a) that the supplier meets the franchisor's specifications, standards and requirements regarding quality, variety, service, safety and health for the equipment, products and services supplied and the facilities used in the production and distribution of such equipment, products and services;

(b) that the supplier has the capacity to supply franchisee requirements;

(c) that the supplier has a sound financial condition and business reputation; and

(d) that the supplier will supply equipment, products or services to a sufficient number of franchisees of the franchisor to enable the franchisor to economically monitor compliance by the supplier with the franchisor's specifications, standards and requirements.

9. Disputes. Whenever practical, a franchisor shall make a diligent effort to resolve disputes with a franchisee by negotiation, mediation, or internal appeal procedures. A franchisor will consider the use of additional alternative dispute resolution procedures in appropriate situations to resolve disputes that are not resolved by negotiation, mediation or internal appeal.

10. Discrimination. A franchisor shall not discriminate in the operations of its franchise system on the basis of race, color, religion, national origin, age, disability or sex. A franchisor may grant franchises to some franchisees on more favorable terms than are granted to other franchisees as part of a program to make franchises available to persons lacking capital, training, business experience or other qualifications ordinarily required of franchisees. A franchisor may implement other affirmative action programs.

ENTERPRISE

New Head of Franchiser Group Stresses Self-Regulation

Embracing Franchisees Will Help Avert Legislation, C. Stephen Lynn Says

By Jeffrey A. Tannenbaum
Staff Reporter of The Wall Street Journal

Embrace the franchisee. That is what C. Stephen Lynn, the new chairman of the International Franchise Association, says franchisers must do to fend off government regulators.

Mr. Lynn, who succeeded Gregg M. Reynolds last month, takes charge of the major franchiser group at a critical time. The industry is one of the fastest-expanding sectors of the U.S. economy — but growing pains have come with the growth.

C. Stephen Lynn

An estimated 2,500 U.S. franchisers license out their names and business formats in exchange for fees and royalties from about 275,000 U.S. franchisees, the IFA says. But concern is growing over several issues, such as encroachment by new franchises on the territory of existing ones within the same chains.

Franchisees also gripe about restrictions that force them to buy supplies from franchisers, and some say their franchises may be unfairly terminated. The complaints have led to bitterness between many franchisees and franchisers, prompting calls for stronger state and federal laws to curb franchisers.

The 45-year-old Mr. Lynn, the chief executive officer of Sonic Corp., a fast-food company in Oklahoma City, says franchisers can police themselves. In an interview, he outlined his vision for getting lawmakers off the industry's back — in part by putting a dispute-resolution program into place at the IFA by the end of the year and by broadening the organization to include franchisees. Excerpts follow:

Q. What's wrong with franchising, and what will you do about it?

A. There's a small level of actual abuses, but there's tremendous fear by franchisees. We haven't had a strong, enforced code of ethics with teeth. Now we are putting together one. We haven't had a trade association working toward self-regulation — but now we are. And we've had an us-and-them mentality toward franchisees, not an inclusionary mentality. If there's one legacy I intend to leave at the IFA, it will be a mind-set change.

My mission by the end of this year is to have alternative dispute-resolution capabilities up and running within the IFA. Also, I want a plan to bring franchisees fully into the membership — and to have that moving along with such momentum that's there's no turning back. That will help us with our grass-roots lobbying. And it will help us to have meaningful dialogue with franchisees about their needs and wants.

Q. Why the emphasis on self-regulation?

A. Look at the alternative: regulators and legislators — who don't understand our business — establishing arbitrary things, such as three-mile protective radiuses for franchisees to prevent encroachment. On the surface, if I were a franchisee, I'd say that makes sense. (A protective radius would legally guarantee a franchisee exclusive territory.)

But when you start digging below the surface, do you really want your business to be controlled by legislators? Do you really want phrases like "good faith and fair dealing" in legislation? What those things mean can only be answered by attorneys and juries. Do you really want units protected by an arbitrary three-mile protective radius when a circle of any size doesn't have anything to do with where customers come from?

Do you really want to tie the good franchisers' hands and not let them terminate mediocre franchisees? The reality is that most franchisees want a franchiser to get the bad ones out, because they're hurting all of us.

Q. Is the threat of expulsion from the IFA enough to deter violations?

A. Every trade association with self-regulation started out where we are starting out, with termination of membership being the most severe penalty. As the self-regulating capability — and the commitment to that process by the membership — grew, other things came along, like fines. We're at a great starting point.

Q. Meanwhile, how can you stave off new laws to curb franchisers?

A. We're confident we'll be able to win those battles. In the short term, we will raise whatever level of war chest we need to make sure new legislation doesn't pass at the state and federal levels. We don't want to specify a figure, but we'll have substantially more lobbying activity in 1993 than there was in 1992.

We think we have the facts on our side; our case is overwhelmingly positive. I don't think legislators understand the job-creation aspects and overall economic impact of franchising. When the industry is working so well, you don't want regulation just to protect a very small minority.

Q. But what about all the reports of franchising abuse?

A. There are some abuses going on — in terminations, nonrenewals, restrictive supplier sources. The most politically contentious things in franchising today are expansion and encroachment. But franchising is working — overwhelmingly well. The vast majority of franchisees are pleased. Failure rates are very low. True abuses are very, very few.

But that doesn't make even one of them fair and right. There are no excuses for abuses to occur, and we need to work on solutions to that.

Q. How can franchisers lessen the tensions in the industry?

A. As a franchiser, I need franchisees more than than they need me. More franchisers need to understand that. It's not that they're doing a bad job for franchisees; this has more to do with style and culture and vocabulary. Taking a top-down, tell-not-sell kind of approach doesn't work with my five-year-old son; it doesn't work with business partners.

When Bill Rosenberg founded Dunkin' Donuts and when Frank Carney founded Pizza Hut they instinctively knew that the franchisee was their customer and partner. They didn't take a top-down approach. They modified their ideas when they heard a better one from a franchisee. Over the years, there has been a style change.

Franchisees, in my judgment, don't want to make final decisions. But they do want meaningful input into decisions affecting their life's work, their sweat equity and their destiny.

Q. How should franchising fare this year?

A. During our recent recession, franchising was growing at a 6% or 7% rate (as measured by the retail sales of franchising systems).

My guess is that we'll perk back up to the 8% to 9% range. Federal deficit reduction, assuming it occurs, will have enormous positive impact on our economy. As long as business isn't over-regulated, overtaxed and overburdened, franchising is going to survive and prosper.

ISBN 0-16-044055-6